

# Question and Answer

## Operator

[Operator Instructions] Your first question comes from the line of Tristan Joll from UBS.

## Tristan Joll

*UBS Investment Bank, Research Division*

Just nicely disclosure format. I guess my first question is just on the revenue mix. And I think I'm right in saying that you've reclassified \$3 million or \$4 million between the 2 main product categories and the historics. What that does reflect? Is it myAIRVO being moved from RAC to OSA?

## Michael Grenfell Daniell

*Non-Executive Director*

Tristan, it's a mix of some AIRVOs that end up in homecare. myAIRVO specifically has been in the homecare or OSA revenue for some time, but there are also some other AIRVOs that end in homecare and also some humidifier controllers and related consumables that end up in homecare. So we felt we had improved the accuracy of that mix. And you've also seen that we have added to OSA the word homecare and we've added to RAC the word hospital, just to clarify that.

## Tristan Joll

*UBS Investment Bank, Research Division*

Yes. Okay, it's good. And then just on RAC and the growth in U.S., I think constant currency at 22%, can you give us a sense or a more granular sense of that by the -- by sort of some product types [indiscernible] oxygen?

## Michael Grenfell Daniell

*Non-Executive Director*

We don't split it out exactly. The big one, as it has been for some time, has been our Optiflow high flow therapy. That's the largest component of our growth. But we're still seeing good growth in the other areas, too.

## Tristan Joll

*UBS Investment Bank, Research Division*

Okay. And then, I guess, 22% there but 11% overall, to what extent in the traditional part of the business will help the traditional part of business going? It sort of suggests a less positive outcome there. And can you kind of comment on whether that's all destocking stuff or whether it relates to other market dynamics, for example, the Teleflex being acquired by somebody?

## Michael Grenfell Daniell

*Non-Executive Director*

It's really entirely due to the change in distribution in the United States where we had that inventory sell-down, and so that clipped a few points of growth off the new apps and of the traditional invasive ventilation. So we are very happy with the underlying growth in both.

## Tristan Joll

*UBS Investment Bank, Research Division*

Okay. And then just, finally, you sort of touched on it before in terms of margin expectations or expansion of margin flowing perhaps in the second half. So you still comfortable with I think it was 100 to 200 basis point range that you've given before. And are we now thinking on the back of this really strong performance that you're probably going to be at the top end of that range for the full year?

## Michael Grenfell Daniell

*Non-Executive Director*

Yes. Well, on the second half, we're probably looking at, if you think of the reported numbers, maybe about 100 basis point improvement in gross margin in the second half versus the first half. But on a constant currency basis, we're looking at them being very similar first half, second half because we will -- we do expect some effect from that, going from a very highly factory situation where we were running production rates above sales rate to build some inventory to probably rate we're definitely running at lower rates in the second half, but that's just a one-off effect from that.

**Tristan Joll**

*UBS Investment Bank, Research Division*

Okay, it's excellent. And then if I could just ask one more. Lewis mentioned a batch of product innovations across the group, and flow gen was part of that. Have you got -- can you give us a bit of sense of what's on the flow gen horizon? Have you got a new one that you're expecting to launch in this next 6 to 12 months?

**Lewis G. Gradon**

*MD, CEO & Executive Director*

So, Tristan, what we've said consistently is that over the next 12 to 18 months, we will have a new complete range of products and that includes flow generators, and that's what we're saying. So...

**Operator**

Your next question comes from the line of Chelsea Leadbetter.

**Chelsea Arna Leadbetter**

*Forsyth Barr Group Ltd., Research Division*

If I can just go back to the gross margin question. I'm wondering if you could give us a bit more insight into the split between product mix, Mexico or manufacturing efficiencies as to that material uplifting gross margin this half.

**Michael Grenfell Daniell**

*Non-Executive Director*

Pretty much broad terms equal from the three, maybe with a slight weighting towards product mix. But you've got product -- I don't know, I think they were listed in order [indiscernible] since our product mix was the big one and followed by Mexico, followed by other efficiencies.

**Chelsea Arna Leadbetter**

*Forsyth Barr Group Ltd., Research Division*

Okay. And then just moving into masks and how you're sort of seeing that pricing environment there and what your kind of competitors are doing with respect to pricing. Have you seen anything change materially over the last 6 months?

**Michael Grenfell Daniell**

*Non-Executive Director*

Well, as I've said in my introductory remarks, we have seen pretty consistent pricing decline similar to what we've seen for many years, in fact, so nothing unusual there. And we have offset those pricing declines with mix. So the average selling price of masks is measured in constant currency and averaged is pretty much identical to what it was a year ago.

**Chelsea Arna Leadbetter**

*Forsyth Barr Group Ltd., Research Division*

Okay. And then just last question around market share in that masks space. You're obviously taking quite a bit of share still there. Have you gotten a better view on where you're kind of sitting and tracking in that space?

**Michael Grenfell Daniell**

*Non-Executive Director*

Yes. Well, the markets -- I don't know exactly where the market's growing. But making the assumption that the market's growing somewhere in the high single-digit 10% range, they'd say, well, clearly, in masks, we're growing well above there. We would estimate today we're around the 15% or so market share in masks.

**Chelsea Arna Leadbetter**

*Forsyth Barr Group Ltd., Research Division*

Okay. And your share of new masks and new products, I guess, is probably higher than that 15%, obviously?

**Michael Grenfell Daniell**

*Non-Executive Director*

Well, it must be to drive -- to be driving that 25% growth in masks.

**Operator**

Your next question comes from the line of Stephen Ridgewell.

**Stephen Ridgewell**

*Craigs Investment Partners Limited, Research Division*

Just a couple of questions, first on OSA. Are you able to just remind us the rollout plan for Eson 2? And also, are you able to give us any comments on early customer reaction to Eson 2 and perhaps compare it to the early reaction to the Simplus mask.

**Michael Grenfell Daniell**

*Non-Executive Director*

The rollout of our typical kind of program of New Zealand, Australia, maybe some countries in Europe and then getting into the U.S. and other markets, we've shown already in Europe. We were up at the big Medica meeting in Europe in the last few weeks and we -- and customers -- and the feedback from customers have been very positive. And so at this point, it looks good but it is very early days, Stephen.

**Stephen Ridgewell**

*Craigs Investment Partners Limited, Research Division*

All right. And would you expect OSA constant currency mask sales growth to dip a little in the second half particularly for the Eson mask as some customers await the introduction of Eson 2?

**Michael Grenfell Daniell**

*Non-Executive Director*

We don't normally see that kind of thing. Probably more significant is that we are lapping some pretty strong growth numbers. So yes, it's quite probable that mask growth rates will come off from that kind of spectacular level that we've just reported.

**Stephen Ridgewell**

*Craigs Investment Partners Limited, Research Division*

Great. And just moving to RAC, have you got any views at this point of the year of the likely strength of the Northern hemisphere flu season? At least are you're seeing the flu strains that you'd expect to see for at least an average flu season?

**Michael Grenfell Daniell**

*Non-Executive Director*

There's good data on the CDC, the Centers for Disease Control website in the U.S. I think I just had a look yesterday, I think it was. And it's -- we're not really into the flu season yet. And if you take a look at that, it's kind of tracking at roughly normal and low levels, which is the case usually at this time in the year in late November. It's not really actually given to later in December and even into January that you get a real feel for what the magnitude of the flu season is likely to be. That obviously has some impact on demand for our respiratory products, but it's not gigantic, but yes, it can make a difference each year depending on how it goes -- but it's too early to tell at present.

**Stephen Ridgewell**

*Craigs Investment Partners Limited, Research Division*

Right. And just in terms of the move to direct distribution in the U.S., are you able to give us a rough guidance to the financial impact, both into the sales growth and at the EBIT level from the decision to go direct during the current half, and maybe what you'd -- a rough guide as to what the impact will be for the full year this year and then do you expect to recover the investment next year?

**Michael Grenfell Daniell**

*Non-Executive Director*

Our net financial impact this year, pretty neutral, really. We're obviously selling now at hospital pricing rather than what you'd characterize as wholesale pricing previously, so that's a 30% to 35% higher price. We're, of course, reinvesting most of that back into an expanded sales force and other infrastructure. So overall, pretty -- it was a drag to earnings slightly in the first half, maybe a more positive in the second half. Overall, pretty neutral. But as we -- as Paul said, as we move into subsequent years, having that focused sales force we believe will be helpful to ongoing growth and in particular, driving adoption of the new therapies that we're offering.

**Stephen Ridgewell**

*Craigs Investment Partners Limited, Research Division*

And in terms of manufacturing capacity, I think in the report, it was mentioned 33% of consumables are now made in Mexico, can you update us on your thinking for need for additional capacity, and at this point whether you'd be tending towards more capacity in open Mexico or elsewhere?

**Lewis G. Gradon**

*MD, CEO & Executive Director*

Sure, Stephen. We think we're probably good with our current manufacturing facilities for about another 3 years, and we are currently going through the exercise of looking at where we would go next. Probably, widely in New Zealand for the bulk of the growth in manufacturing.

**Michael Grenfell Daniell**

*Non-Executive Director*

And short term, as you know, we've already expanded the cycle or the area of manufacturing in Mexico. We're now currently engaged in putting manufacturing equipment over there. So over the next couple of years, most of the growth in consumables manufacturing will go into Mexico.

**Stephen Ridgewell**

*Craigs Investment Partners Limited, Research Division*

And last one for me. Just in terms of the guidance, what is the extreme level of hedging loss for the year?

**Antony G. Barclay**

*Consultant*

So, Stephen, we -- at these rates, we obviously saw \$7 million in the first half. We are assuming 7 -- sorry, just under \$14 million for the full year. It's obviously getting slightly better as we're working through some of the high-engine rates that we've got.

**Operator**

Your next question comes from the line of Victor Windeyer.

**Victor Windeyer**

*Citigroup Inc, Research Division*

I just wanted to ask a bit about that 22% growth in the new applications and I think 11% in respiratory in 2Q[ph] but obviously affected by the sell-down from your existing inventory in the channel, up to a 14%-ish, does that mean that the new applications growth rate is probably more 26%, 27%, and we can expect that going forward? Is that a reasonable assessment of that -- those numbers?

**Michael Grenfell Daniell**

*Non-Executive Director*

Yes, mid-20% is a reasonable number, and we've been growing those new applications in that mid-20s range for quite some time. And certainly our aspiration for the future is to continue to grow in those 20s range.

**Victor Windeyer**

*Citigroup Inc, Research Division*

And what sort of penetration do you think you've got in that market? I mean, is that still -- in terms of converting the noninvasive vents and hospitalize it to higher flow and then where do you think you are in that journey?

**Michael Grenfell Daniell**

*Non-Executive Director*

Under 10% penetration at this point, so there's a lots of headroom in it.

**Victor Windeyer**

*Citigroup Inc, Research Division*

Yes. Okay, great. And then just in terms of the SG&A, obviously we haven't had the full impact in the half. I guess that for the full year and then I think we're talking about \$20 million before, is that still broadly the expectation? Or what do we expect there in terms of, albeit FY '16 or on FY '15?

**Michael Grenfell Daniell**

*Non-Executive Director*

Yes, we will have the full cost of the expanded sales team and support infrastructure in the U.S. in the second half. I think in a constant currency, it seems we're looking at SG&A growth probably around 20% or so in the second half, so above revenue growth as expected and as planned. But that will be offset by the additional margin as well from selling directly in the U.S.

**Victor Windeyer**

*Citigroup Inc, Research Division*

Yes, okay. So the real benefit then comes through in '17 in terms of your annual OpEx increase cost.

**Michael Grenfell Daniell**

*Non-Executive Director*

Yes, that's right. Yes. And as I said earlier, the primary benefit we see is focus. And -- but there's also obviously room for modest improvement in operating margin as well from the net result of that.

**Victor Windeyer**

*Citigroup Inc, Research Division*

Yes, okay. And then just on myAIRVO, can you describe for me, in terms of the growth profile for that particular device, what do you see to that? I mean, in terms of reimbursement and so on and so forth, how do you anticipate that might go in the next couple of years?

**Michael Grenfell Daniell**

*Non-Executive Director*

It's going very strongly. And we are building up an increasing base of patients in the market and as those patient numbers grow and patients are purchasing myAIRVO themselves, various organizations are funding it, but, yes, we don't as yet have specific reimbursement codes. And as the numbers of patients grow, we think the opportunity of giving those specific reimbursement codes will improve. So -- but we're happy with the progress we're making.

**Victor Windeyer**

*Citigroup Inc, Research Division*

Okay. And is there -- are those numbers incorporated into the flow generator, negative 14% constant currency growth?

**Michael Grenfell Daniell**

*Non-Executive Director*

Into the total number, yes.

**Victor Windeyer**

*Citigroup Inc, Research Division*

Okay. And -- well, that's terrific. Just on masks, you're obviously doing extremely well in masks, which is great and well done. But what do you anticipate will happen with competitive bidding round 3?

**Michael Grenfell Daniell**

*Non-Executive Director*

Well, we've been through a number of rounds of various changes in reimbursement and bidding there. And through having great technology, we've been able to maintain our average selling prices, and we'll be working hard to continue to do that.

**Victor Windeyer**

*Citigroup Inc, Research Division*

Yes. Okay. I mean, it looks like last time around, there were some price disruptions in the market in general, obviously benefited Fisher & Paykel or in a relative sense. So just wonder in terms of as we move forward now, you'll have a premium product in the marketplace. How do you see whether you're positioned in that sense?

**Michael Grenfell Daniell**

*Non-Executive Director*

Well, it's our intention to continue to offer masks that do a great job, that are easy to fit, that are comfortable, don't -- that don't leak.

**Operator**

[Operator Instructions] Your next question comes from the line of Ian Abbott.

**Ian Abbott**

*Goldman Sachs Group Inc., Research Division*

Can I ask around the OSA market? If you look both in the U.S. and also in Europe, can you -- are you able to give an idea as to what you think new patient growth is across the market in the U.S. and some of the major countries in Europe?

**Paul N. Shearer**

*Senior Vice President of Sales & Marketing*

In -- Paul here. I think that the new patient growth are probably similar between markets, really, but it's really hard to get that information. But we don't see a big difference between the European market or the U.S. market.

**Michael Grenfell Daniell**

*Non-Executive Director*

And in terms of the numbers, again, hard to know, but maybe in the high single digit. I mean, really, it's that disclosure in this area has become pretty limited now, of course. So it's very hard to get a hard data on it.

**Ian Abbott**

*Goldman Sachs Group Inc., Research Division*

Sure. I suppose to ask a similar question in Europe, which countries are you particularly pleased with for your performance in OSA in recent -- in the last half?

**Michael Grenfell Daniell**

*Non-Executive Director*

As you know, we don't really disclose that. I think it'd be a fair comment to say that we have enjoyed a growth across Europe.

**Operator**

[Operator Instructions]

**Michael Grenfell Daniell**

*Non-Executive Director*

Okay, Jade. Well, it doesn't sound like we have any more questions. So I'd just like to conclude by saying that the team around the world are very proud, really, of the results that we are achieving and committed to continuing to help improve care and outcomes with better and better technology. 3,500 people now located across 35 countries, so really like to recognize what they've done and what they're achieving.

But I'd also like to note in closing that this will, in fact, be my last 6 monthly results call as CEO, and I've just been saying to the team here, I'll be looking forward to calling in, in May and hearing what they have to say. So thank you very much, and goodbye.

**Operator**

Ladies and gentlemen, that does conclude our conference for today. Thank you for participating. You may all disconnect.