

Question and Answer

Operator

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

Tristan Joll

UBS Investment Bank, Research Division

Just a few questions. I guess, the first one is the mask performance is obviously very impressive and getting better in the second half. There have been some competitor launches, I note. Are you still seeing that level of momentum, 26% constant currency growth into this half? And then the other question on that, I'm sorry, the other question I was just going to say on that was you might have mentioned it before, but could you give a price volume sort of breakdown of that 26%?

Michael Grenfell Daniell

Non-Executive Director

We are continuing to see very good growth in masks. It is worth noting that as we go through the year, we will be lapping the introduction of masks that we made in the prior period. So it might be a big ask to expect that kind of very high growth to continue. With respect to competitors, yes, there's a number of competitors out there with new products, but we feel as if we're in a good position with what we have.

Tristan Joll

UBS Investment Bank, Research Division

Okay. And then the volume price, so the contribution to 26%?

Michael Grenfell Daniell

Non-Executive Director

Yes, well, obviously, mostly volumes, but 2 or 3 or 4 depends on the mask percentage points from price. We're obviously seeing a mix shift now with Simplus growing very strongly as we mentioned. And Simplus being a full face mask does sell at a higher price and is reimbursed at a higher level in the U.S.

Tristan Joll

UBS Investment Bank, Research Division

Yes. And I guess that was my point though, you are getting price growth as well as volume growth.

Michael Grenfell Daniell

Non-Executive Director

Yes.

Tristan Joll

UBS Investment Bank, Research Division

And then if I can just ask, around the guidance, I see you've got the headwind comment about the currency, which I think is -- I think the number is \$32 million. What are you -- what component of that is the stick down in the hedge gain? That, to me, looks like it's mostly the hedge gain.

Michael Grenfell Daniell

Non-Executive Director

Yes, it is. Tony's having a look at the numbers. But it's mostly hedge gain, a little bit from spot rate movements and quite surprised as, of course, we've been signaling that for some years now. What we're feeling particularly good about is the position where are in to offset that now with accelerating revenue growth and with gross margin expansion and the opportunity to take some operating leverage.

Antony G. Barclay

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Just the hedging head run is about \$20 million of the \$32 million and the rest is relative spot rates compared to where we are today versus where we averaged last year.

Tristan Joll

UBS Investment Bank, Research Division

Okay, that's very useful. And then just finally, and I'm not particular schooled on this, but we're getting a bit of news through about potential changes to CMS' preauthorization on CPAP? Can you talk a bit about that? Do you know much about that? Or what is the fixed may be?

Michael Grenfell Daniell

Non-Executive Director

We not -- we don't have information on that at present.

Paul N. Shearer

Senior Vice President of Sales & Marketing

Not on CPAP, but potentially -- maybe it could be relating to home sleep studies.

Michael Grenfell Daniell

Non-Executive Director

We can't comment. We're not sure what that refers to.

Operator

Our next question today comes from the line of Marcus Curley of Goldman Sachs.

Marcus Curley

Goldman Sachs Group Inc., Research Division

Can we talk little bit about the RAC business? First of all, within the result, obviously, impressive outcomes for new applications. Can you give a little bit more color in terms of the key drivers for behind that growth?

Michael Grenfell Daniell

Non-Executive Director

Yes, well, the 3 areas we're in there, of course, is noninvasive ventilation oxygen therapy with our Optiflow system running from adults right through to neonates; our AIRVO systems, also used for Optiflow delivery and humidity therapy in the hospital and in the home; and then finally, surgical applications for our humidification. And all of those are growing very decently. I think you'd have to say the standout is Optiflow. In fact, surgical is growing very strongly off a much, much smaller base. So if you think of materiality to growth, that's -- it's the Optiflow and AIRVO products that are driving the most of that.

Marcus Curley

Goldman Sachs Group Inc., Research Division

So it's probably the first time on the call that you've mentioned AIRVO as a material contributor to growth. Who's purchasing that product at the moment?

Paul N. Shearer

Senior Vice President of Sales & Marketing

It's Paul here, Mark. It's across the board. One of the big advantages we've got there, we've got registration of AIRVO in different markets around the world. We're selling it both into home care and into acute care, and we're basically using AIRVO as flow source to Optiflow. So it's very interlinked in. And we're getting very high growth in Optiflow, and so therefore, that's pulling in the AIRVO sales.

Marcus Curley

Goldman Sachs Group Inc., Research Division

So principally, hospital sale at the moment?

Paul N. Shearer

Senior Vice President of Sales & Marketing

A lot of it is going into acute care, yes.

Michael Grenfell Daniell

Non-Executive Director

More than half is into the hospital.

Paul N. Shearer

Senior Vice President of Sales & Marketing

Yes.

Marcus Curley

Goldman Sachs Group Inc., Research Division

And -- but not to be forgotten about, it looks like a decent outcome certainly with the traditional intensive care business. Can you give a little bit of comment in terms of has that been volume or has it been greater share consumables? What's happening in that business?

Michael Grenfell Daniell

Non-Executive Director

Yes, it's combination of factors. We -- the market is growing. We've got an aging demographic around the world. You've got developing markets putting more into health care. It's hard to get a real handle on that. But we are thinking 5%, 6%, 7% even, could be the growth in the invasive ventilation patients each year. We are growing with that. We are also getting growth from better technologies that were introduced, in particular our Evaqua breathing circuit technology is helping to drive growth there also.

Marcus Curley

Goldman Sachs Group Inc., Research Division

And then just switching to your guidance, mid-teens for this division, more of the same? Is that how we should read it? Or is there any specific thing you would like to call out in terms of what you're thinking about in terms the guidance?

Michael Grenfell Daniell

Non-Executive Director

Yes, well, the big driver of growth again, we expect, will be those new applications growing at a much faster rate than the traditional component of the business. It's pretty worth noting that if you look back to the first half last year, we had quite exceptional growth in respiratory. I'm thinking 18% or so, I think, in the first half, constant currency. That was driven partly by -- no, no, dropped off. We gave guidance for 18%. But we had, in the first quarter, we had very, very strong growth as a result of our U.S. hospital distributor building some inventory, which are then sold down. So we may be up against a slightly tougher comp on the first half.

Marcus Curley

Goldman Sachs Group Inc., Research Division

And then just finally from me. You mentioned the SG&A guidance -- I'm sorry, you mentioned the gross margin guidance at up to 100 points. Can you talk a little bit about what level of your manufacturing that represents in Mexico? One would assume that that's the key driver of that and you're probably talking mix improvement as well. So maybe you can just talk a little bit about what's driving that sort of growth?

Michael Grenfell Daniell

Non-Executive Director

Yes, there are really 3 components that are relatively equal. You've got product mix with newer products and newer technologies and new applications at better margins. You've got Mexico. And then you've got efficiencies in the manufacturing operation in New Zealand and some logistics efficiencies. And they're roughly about 1/3, 1/3, 1/3. I mean, it varies on the period and the like, but each of those 3 are quite material. Yes, we will be growing in Mexico. We've got a number of product lines being commissioned in Mexico at present and that will be ongoing. I'll just check with Lewis what's the kind of run rate of consumables out for the present? High 20s or -- high 20s or 30% or so, the run rate of consumables output there at present.

Marcus Curley

Goldman Sachs Group Inc., Research Division

And it sounds, by your comments around the improvement in gross margin over time, that given your printed constant currency growth margin about 55%, are you sort of targeting 60% on a long-term basis?

Michael Grenfell Daniell

Non-Executive Director

Yes. We think that that's doable, unhedged at least kind of exchange rates. But you'll need to give us another 2 or 3 years to get there.

Operator

Our next question today comes from the line of Daniel Frost of Macquarie.

Daniel Frost

Macquarie Research

I've just got a question on your guidance. I just want to clarify, the \$640 million of operating revenue, does that include any hedge gains?

Antony G. Barclay

Yes, it does.

Michael Grenfell Daniell

Non-Executive Director

Yes, it does.

Operator

Our next question today comes from the line of Sarndra Ulrich of First NZ Capital.

Sarndra Ulrich

Jarden Limited, Research Division

So just a couple of questions. Flow generator, you've talked about OSA being around the 5% mark. That sounds a bit low to me and I wondered if you could just clarify that, firstly.

Michael Grenfell Daniell

Non-Executive Director

It's probably around or even a little above market growth rate in flow generators. When you look at the dynamics of the OSA market, in particular, even constant value of flow generators each year generates mask growth because the installed base patients are increasing. So when you look at what other systems in the market are being reported, it doesn't slide. The flow generator market is growing at the lower end of the market growth range. So that said, we are probably at or above our market growth there. Reality is, of course, we're putting emphasis on so many new masks out there on mask sales.

Paul N. Shearer

Senior Vice President of Sales & Marketing

Paul, Sarndra. I'd like to chip in and say that we released ICON+ in the second half that showed an improvement because you have to remember that we're transitioning out of SleepStyle. Most of our business now is coming out of ICON. We saw a lift in the second half as we released ICON+.

Sarndra Ulrich

Jarden Limited, Research Division

Okay. So I'm having a bit of a brain freeze here. But in terms of the 26% growth in masks, are they attaching to other manufacturers' CPAP machines? Is that right or...

Michael Grenfell Daniell

Non-Executive Director

Yes, we think that the majority of the masks we place go on to other manufacturers' flow generators.

Sarndra Ulrich

Jarden Limited, Research Division

Okay. And just secondly, just coming back to the guidance, what -- or I guess my first question is, are you -- even at the 86%, are you potentially being conservative? And if I was looking at just to work out the sensitivity of the sales, I was looking at the lower 80s, I should say around 82%, 83%. Is there anything to say that you couldn't get to \$110 million for FY '15?

Michael Grenfell Daniell

Non-Executive Director

If the exchange rates were very helpful to us, anything is possible. That would be a bit retro to be talking at this stage. Our guidance is similar earnings in FY '15 to FY '14. As we go through the year, we'll be reviewing that. But that's the number we're comfortable with at present.

Sarndra Ulrich

Jarden Limited, Research Division

But I guess if I could put it another way, in terms of the [indiscernible] sensitivity, around earnings sensitivity, around \$0.01 movement in the currency, can you give me that at least to work out?

Antony G. Barclay

Sarndra, if we were guiding today at say 80% against the U.S. dollar and 60% against the euro, we'd be closer to sort of \$104-or-so million. So not quite your \$110 million, but certainly as you're implying above the \$100 million, is my view. We'll see our volume and ASPs go from here.

Operator

Our next question today comes from the line of Nachi Moghe of Morningstar Research.

Nachiket Moghe

Morningstar Inc., Research Division

Just on the AIRVO, could you sort of give us a feel of what sort of pricing are you achieving in that product?

Michael Grenfell Daniell

Non-Executive Director

Paul?

Paul N. Shearer

Senior Vice President of Sales & Marketing

Yes, we don't like getting too much into pricing, Nachi, but we're getting more for AIRVO than we would for our traditional controller and it varies market to market.

Nachiket Moghe

Morningstar Inc., Research Division

Yes, yes, okay. Are you getting sort of more pricing in the home care or in the hospital care? Or is it similar?

Paul N. Shearer

Senior Vice President of Sales & Marketing

It's relatively similar, at little bit lower possibly in home care because you've got another margin in the chain.

Michael Grenfell Daniell

Non-Executive Director

And lower price compared the hospital, but it is worth noting that AIRVO is at least as good as a high-end humidifier controller or better in the hospital setting. And of course, it's well above flow generator pricing for CPAP devices in the home care setting.

Nachiket Moghe

Morningstar Inc., Research Division

Okay, that's good. And where does this actually sit? Does it sit in the OSA division or does it sit in your RAC division at the moment?

Michael Grenfell Daniell

Non-Executive Director

We report the hospital sales in RAC and home care sales in OSA.

Nachiket Moghe

Morningstar Inc., Research Division

Okay, okay. And the other one was the \$15 million R&D credit that is talked about. Is that also -- is it like \$5 million for this year and then \$5 million total 2017? Or is that included in your guidance as well? Or how -- is that including...

Antony G. Barclay

Yes. Nachi, it's Tony here. That's \$5 million in the '15 year, that \$5 million in the '16 year. They were not talking about years. And then the first \$2.5 million of that under the first half of '17 year.

Nachiket Moghe

Morningstar Inc., Research Division

Right, so this \$5 million is pretax, right?

Antony G. Barclay

Correct. It is effectively taxable.

Nachiket Moghe

Morningstar Inc., Research Division

Excellent, okay. And the other one was you talked about scaling back SG&A and R&D in the year 2015. But in the -- but beyond that, 2016 and onwards, do you expect SG&A and R&D to sort of grow in line with revenue growth? Or sort of how should we think about that?

Michael Grenfell Daniell

Non-Executive Director

We obviously plan to grow both of them quite strongly, in fact. But yes, in FY '15, we expect to grow SG&A 2 or 3 percentage points slower than revenue growth. R&D may be slightly under revenue growth. As we

move into FY '16, we'll make our decision then. But as a general principle, we would be growing both at or slightly below revenue growth in the future. But this year, given that we've made a big investment on both over the last few years under the cover of vary favorable hedging, we're going to take the opportunity to drive better leverage to help offset that hedge roll-off.

Nachiket Moghe

Morningstar Inc., Research Division

Right, right. And finally, on the CapEx, the CapEx guidance that you've given, \$50 million to \$55 million, what does that include? I mean, it's well above what I was expecting. I was sort of in the \$40 million mark. So could you just talk through what the -- what are the main drivers of CapEx in 2015?

Michael Grenfell Daniell

Non-Executive Director

The biggest driver, there's always our new products that are been tooled and new production lines for those products. And being the next driver is increases in capacity for products introduced in prior years as we grow. Those are the biggest drivers and there's other miscellaneous items, IT and the like. And as Tony said when he was making comments on that, we are reaching some quite important milestones on some very exciting new products that are coming in the future. So that's just bumping CapEx up a little.

Operator

[Operator Instructions] And our next question from the line of Marcus Curley of Goldman Sachs.

Marcus Curley

Goldman Sachs Group Inc., Research Division

Sorry, guys, one more for me. Can you just give us any color in terms of how far through, I suppose, the demise of the SleepStyle you are relative to your other flow generators?

Paul N. Shearer

Senior Vice President of Sales & Marketing

Sorry, SleepStyle, as a percentage, is reported of our total volume is less than 15% there, Marcus. And we're just transitioning out of that and that will continually decrease over time.

Michael Grenfell Daniell

Non-Executive Director

Probably more than year to go before it drops down to -- off the list completely.

Operator

As there are no further questions, I will now hand the call back for closing remarks.

Michael Grenfell Daniell

Non-Executive Director

Thanks, Alberto. Well, as you can imagine, our teams here in New Zealand and right around the world are, in fact, very proud of the results we have achieved and are very excited by the opportunities that we have to increase the number of patients that we can assist and -- right across a broad range of applications. And I really like to take this opportunity to acknowledge those 3,000 people and what they have contributed to our results and what they've got in mind for the future. And thank you, everyone, for joining us today.

Operator

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