Q2 2020 Earnings Call

Company Participants

- Calvin Darling, Senior Director, Finance & Investor Relations
- Gary S. Guthart, President and Chief Executive Officer
- Marshall L. Mohr, Executive Vice President & Chief Financial Officer
- Phillip Kim, Head, Investor Relations

Other Participants

- Amit Hazan, Analyst
- Bob Hopkins, Analyst
- David Lewis, Analyst
- Larry Biegelsen, Analyst
- Larry Keusch, Analyst
- Rick Wise, Analyst
- Tycho Peterson, Analyst

Presentation

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Intuitive Q2 2020 Earnings Release. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. (Operator Instructions) As a reminder, this conference is being recorded.

Now, I'd like to turn the call over to Senior Director of Finance, Investor Relations for Intuitive Surgical, Calvin Darling. Please go ahead.

Calvin Darling {BIO 17664656 <GO>}

Thank you. Good afternoon, and welcome to Intuitive second quarter earnings conference call. With me today, we have Gary Guthart, our CEO; Marshall Mohr, our Chief Financial Officer; and Philip Kim [ph], whom I'm pleased to introduce our Head of Investor Relations. As for me, while passing the lead over to Phil, I plan to continue on in a support role with our Investor Relations team.

Before we begin, I would like to inform you that comments mentioned on today's call may be deemed to contain forward-looking statements. Actual results may differ materially from those expressed or implied as a result of certain risks and uncertainties. These risks and uncertainties are described in detail in our Securities and Exchange Commission

filings, including our most recent Form 10-K filed on February 7, 2020 and Form 10-Q filed on April 17, 2020.

Our SEC filings can be found through our website or at the SEC's website. Investors are cautioned not to place undue reliance on such forward-looking statements. Please note that this conference call will be available for audio replay on our website at intuitive.com on the Latest Events section under our Investor Relations page.

Today's press release and supplementary financial data tables have been posted to our website. In addition, this quarter, we have also posted chart, illustrating 2020 weekly da Vinci procedure trends, which is intended to provide additional perspective and detail regarding the impact of COVID-19 on our business.

Today's format will consist of providing you with highlights of our second quarter results as described in our press release announced earlier today followed by a question-and-answer session. Gary will present the quarter's business and operational highlights. Marshall will provide a review of our financial results. Then Philip [ph] will discuss procedure details. And finally, we will host a question-and-answer session.

With that, I will turn it over to Gary.

Gary S. Guthart {BIO 3429541 <GO>}

Thank you for joining us today.

On this call, we'll describe our experience in the quarter, the actions we are taking and our priorities going forward. Our focus now and in the past is the safety and well-being of patients, care teams, our communities and our employees.

Turning first to global procedures. We ended Q2 2020 down 19% compared with Q2 2019. The underlying driver for this decline has been the growth of COVID-19 and the communities that our customers serve. While we saw procedure declines in all categories, urology and thoracic procedures were relatively resilient, while gynecology experienced the greatest decline.

Rates of recovery from lows by procedure type were more uniform. We've seen hospitals with adequate supplies of staff, PPE and physical resources return to above 90% of pre-COVID procedure run rates over a few months period. Recovery above this number is dependent upon the intensity of COVID in the region, patients' comfort to return to the hospital, availability of testing and patient outreach. As we stand here in July, we see the continued growth of COVID in some regions, both domestically and internationally, making future predictions on hospital capacity for surgery difficult. Philip will take you through some examples of regional differences in procedure trends later in the call.

With regard to capital placements, we installed 178 new systems in Q2 2020. This compares to 273 installs in Q2 2019 and 237 installs in Q1 2020. The new -- the new installs

in Q2 2020 represent a clinical installed base growth of 9% after accounting for trade-ins. While these numbers are lower than prior year and prior quarter, frankly, they are greater than our expectation coming into the second quarter due to strong performance in Asia and some larger IDN placements in the US.

That said, we know the correlation between system utilization in the form of procedure demand and capital availability of hospitals is a strong one. Hospitals will seek to absorb existing capacity before installing the capital. So on average globally, we expect a challenging near to mid term environment for future capital placements as COVID-19 wears on, and hospital expenditures remain constrained. Because COVID is impacting locals differently, we see significant variability in procedure growth and new system placement interest by region. Marshall will take you through capital placement trends and risks later in the call.

Stepping back and evaluating hospital approaches to surgery during this period, we see some principles that are being applied broadly. During [ph] local rapid growth of COVID in a hospital catchment area, their initial response is to align and train their workforce, stabilize there PPE and testing capability. And if ICU resources are scarce, the first surgeries that can be delayed with a managed risk to the patient. As staff material in ICU resources free up, either by diverting patients to alternative sites of care or within the four walls of the hospital, Program Directors triage patients in need of surgery and ramp back up.

As sites become less impacted, we have observed that outreach, education and diagnostic business and procedures come back. The surge of COVID in communities that represent our core markets, either from initial spread or secondary growth is occurring now. Add to the significant anecdotal evidence of delayed diagnostic visits for non-COVID illness and we expect that the recovery tale of surgery will be a long one, likely to last many quarters.

The ultimate timing and shape of the recovery remains uncertain. The drivers of a sustained recovery in surgery will likely vary regionally and may be predicated on the extent and duration of COVID outbreaks, the availability of human, material and physical resources to concurrently treat both COVID and other disease, patient comfort in returning to care centers for diagnostics or treatment and finally, the relative health of the broader economy and hospital finances.

At Intuitive, we're focused on those activities and priorities within our control. They are as follows. First, we're focused on the health and well-being of our customers, our employees and our communities. As COVID has ramped in our communities, we instituted employee health and safety protocols and have been tracking our performance and refining our methods. We are also working with our foundation and others to produce and donate PPE for customers and the communities in which we work and live, having delivered to date over one million pieces of PPE.

Second, we focused on inventory and supply chain management. So far, product availability has been strong, thanks to the relentless work of our supply chain teams and

our partners. Third, we implemented our customer financial relief program in the quarter. The timeliness and the design of the program has been well received by our customers.

Fourth, we continue to invest in our high priority programs, recognizing that high-quality MIS is likely more important in the coming years post-COVID, not less so. If we are evaluating those activities, that should be accelerated in the in-current environment and for which demand is likely to be durable post-COVID. Finally, we are constraining spend where we believe it is sub-optimal in the current environment.

Turning to instruments. Beginning Q4 this year, we plan to introduce an updated set of select EndoWrist instruments for use with da Vinci X and Xi, that will enable increased use beyond the current 10 years lifespan, part of our Extended Use Program. Extended use will vary from two to eight additional uses per instrument, and is the result of continuous and significant investment in the design and production of our instrument technologies that have resulted in improved quality and durability.

In addition, we'll concurrently lower the price of some other instruments that are most commonly used in lower acuity procedures. We are dedicated to support our customers' pursuit of the quadruple aim, to find us better patient outcomes, better patient experiences, better care team experiences and lower total cost to treat per patient episode. The long-term opportunity for our products and services is substantial, both in high-acuity complex procedures and in shorter duration lower acuity cases where customers are understandably more cost sensitive.

So EndoWrist instruments are used in every procedure, so our Extended Use Program helps all customers and in particular those performing lower acuity cases, which are among the fastest growing procedures. As the program rolls out, I&A cost per customers performing lower acuity procedures will be highly competitive with non-robotic MIS approaches.

I have described our commitment to a virtuous cycle of value adjustment for our customers driving volume increases, allowing us to invest in design and manufacturing at scale and giving us the opportunity to share these savings with our customers to allow them to use our products more broadly. This program is another step in this journey.

Our Extended Use Program has been years in the making and it's timing is fortuitous relative to COVID. We are pleased to bring it to our customers now. The program will negatively impact our near-term revenue, but not substantially impact our gross margin for affected instruments. It is the right decision for our customers and therefore for Intuitive long-term.

Marshall will take you through financial implications of this program later in the call.

Turning to advanced instruments or da Vinci Energy platform, which includes our next-generation energy instrument and system, SynchroSeal or E-100 have made surprisingly good commercial progress in the second quarter in spite of current environmental challenges. A testament to customer reception to its speed and precision, we also

initiated our first commercial cases for E-100 and SynchroSeal in Japan in the quarter. And lastly, our 45 millimeter SureForm Stapler launched in Europe in the second quarter.

Turning to other programs of interest, our Ion program continues to march forward in the face of COVID headwinds. Three systems were placed in the quarter and our clinical trial is progressing. Design and manufacturing teams continue to make progress on incorporating learnings to allow us to drive towards wider distribution in the future. While our progress in our PRECISE trial for Ion has been slowed, we're seeing a return to cases as our clinical trial partners complete.

For our SP program, our teams continue to support our early customers. Average monthly utilization for SP in Korea continues to exceed that of Xi, a strong positive that speaks to early interest in the platform by surgeons and their patients. In addition to our learning from Korea, we are working with regulatory agencies regarding expansion of indications. The regulatory environment in the US and the EU has become more complex for new systems over time, made more challenging by diversion of resources at hospitals and at regulators to fight COVID, which impacts clinical trials and regulatory reviews. We'll update progress on additional indications for SP as we have greater clarity.

In our intelligence and analytics programs, our teams are performing well, and we are leveraging our prior investments in cloud computing, training technologies and analytics prowess. We've focused on our integration of cloud technologies within InTouch to accelerate access to remote partnering in certain regions. We had already moved to a network subscription model for our simulation technology platform called SimNow, which is helping us decrease travels for surgeons for some elements of surgical training. Use of our hospital analytics programs is accelerating even through the turbulence of 2020, helping hospitals and us in planning for system use in dynamic times like these.

Before concluding my prepared remarks, let's step back. We cannot yet see the end of the COVID-19 pandemic. When the lessons from this event are absorbed, I believe high-quality, minimally invasive care will be more important to the future, not less so. The balanced approach to improving the quadruple aim remains our North Star.

Our priorities for the next few quarters are as follows. First, continued strong performance on customer, employee and community safety while ensuring supply chain stability. Second, continued support of our customers adapted to their specific conditions, different customers are at different stages in this period and we will support them according to their needs. Third, advancing our priority programs; instruments, accessories, endoscopes, endoscopy systems and intelligence programs and finally, disciplined spend management during a period of change.

I'll now turn the call over to Marshall, who will take you through financial matters in greater detail.

Marshall L. Mohr {BIO 5782298 <GO>}

Good afternoon.

I would describe the highlights of our performance on a non-GAAP or pro forma basis. I will also summarize our GAAP performance later in my prepared remarks. A reconciliation between our pro forma and GAAP results is posted on our website.

Key business metrics for the second quarter were as follows. Second quarter 2020 procedures decreased approximately 19% percent compared with the second quarter of 2019, and decreased approximately 22% compared with last quarter. Second quarter system placements of 178 systems, decreased 35% compared with 273 systems last year and decreased 25% compared with 237 systems last quarter. We expanded our install base of da Vinci systems over last year by 9% to approximately 5,764 systems. This growth rate compares with 11% last quarter and 13% last year. Utilization of clinical systems in the field, measured by procedures per system declined approximately 27% compared with last year, and declined 23% compared with last quarter.

Let me walk through the impact of COVID-19 pandemic on procedures and system placements and how it varied by market. The impact of COVID-19 varied significantly among geographies. To assist in your understanding of this dynamic, we have posted a graph showing US, China, Japan and Germany procedures in Investor Relations portion of our website.

In that graph, we compare procedures to the average of the first two complete weeks of the first quarter, which we have characterized as pre-COVID-19 levels. In US, procedure volumes started the second quarter at around 30% of pre-COVID-19 levels. And grew by the middle of June to nearly the level measured in the first two weeks of the first quarter.

However, with the resurgence of COVID-19 regionally in the US and related deferrals of elective surgeries, procedures began to decline in the last weeks of the quarter. We expect to see da Vinci surgeries declined further in July, as the pandemic continues to spread and hospitals dedicate human and physical resources to the treatment of COVID-19 and away from other procedures.

Second quarter procedures in China, Japan and Korea grew well year-over-year as COVID had a lower impact on these markets. In Europe, the impact of COVID varied widely, with Germany experiencing year-over-year single-digit growth, while France, UK, and Italy experienced large declines.

Capital sales in the US and Europe reflected lower procedures and delayed capital spendings -- spending, while hospitals revisit their capital budgets given the impacts of COVID-19. On the other hand, capital sales in several of our Asia direct markets including China, Japan and Korea were better than anticipated.

System placements will likely continue to be pressured by hospital spending, reflecting the impact of COVID-19 and result into economic pressures. Also, as system utilization declined by 27% year-over-year, hospitals have excess capacity that they will likely seek to fill before purchasing additional systems. The extent and duration of COVID-19 and subsequent resurgences in the US and other parts of the world is uncertain. The time and extent to which da Vinci procedures may recover will vary by market.

However, as we believe surgery is durable and that the long-term worldwide opportunity for robotic assisted interventions remain significant. Additional revenue statistics and trends are as follows. Second quarter revenue was $852 million, representing a 22% decrease from last year and a 23% decrease from last quarter.

Under the previously announced Customer Relief Program, we are providing service credits to customers related to lower use of their systems during the second and third quarters as hospital treat COVID patients. Revenue reflects $59 million of service credits granted to customers in the second quarter. As procedures in the US and Europe recovered more quickly in the second quarter, the credits issued were less than expected. We are now anticipating the total cost of the Customer Relief Program will be in the range of $80 million to $110 million.

Second quarter placements included 21 into China, representing a greater proportion of total placements relative to the prior year and prior quarter. As leasing is prohibited in China and most systems replaced within greenfield hospitals, the worldwide percent of leasing and trade-ins has declined.

Leasing represented 29% of current quarter placements compared with 32% last quarter. Trade-ins represented 40% of current quarter placements compared with 57% last quarter. We would anticipate in an environment of COVID-19 as economic pressures increase, more customers will seek leasing or alternative financing arrangements than reflected in historical run rates.

Trade-in activity can be fluctuated and be difficult to predict. We recognized $9 million of lease buyout revenue in the second quarter compared with $12 million last quarter and $27 million last year. Lease buyout revenue has varied significantly quarter-to-quarter and will likely continue to do so.

Instrument and accessory revenue per procedure declined to approximately $1,900 per procedure compared with just over $2,000 procedure in the first quarter of 2020, reflecting hospital usage of existing inventory as procedures declined.

We expect instrument and accessory revenue per procedure to fluctuate, as hospitals adjust inventories to reflect changes in procedure volumes.

Earlier today, we announced our Extended Use Program under which, in October, we will launch selected X and Xi instruments possessing 12 to 18 uses compared with our existing 10 use instruments. These extended use instruments represent our higher volume instruments, excluding Stapler, Monopolar and advanced energy instruments, and are used in a broad set of procedures. The announcement is posted on our website.

Our ability to introduce instruments with extended uses is the result of significant investments in quality and manufacturing processes over a long period of time. The extended use instruments will generally be priced higher than our 10 life instruments, reflecting the instruments -- the investments we have made. But the cost per use will be lower for our customers.

In addition and simultaneously, we will lower the price of certain instruments used commonly in lower acuity procedures and/or lower reimbursement procedures like cholecystectomies, inguinal hernias and benign hysterectomies in the US.

Combined with the savings associated with extended use instruments, the result into instrument and accessory cost for these procedures will be competitive with nine robotic MIS approaches.

Overall, extended use instruments and lower instrument pricing will result in lower I&A revenue per procedure to Intuitive. For example, had the extended use instruments been available and the lower instrument pricing been in place for all of 2019, revenue for 2019 would have been $150 million to $170 million less than reported and I&A per procedure would have been 7% lower.

The impact of these actions on future revenue will be dependent upon procedure volumes, instrument usage, mix and whether cost elasticity will enable greater penetration into available markets. Five of the systems placed in the second quarter were SP systems, reflecting both our measured rollout of SP and the impact of COVID-19. Our rollout of SP surgical system will continue to be measured, putting systems in the hands of experienced da Vinci users, while we pursue additional indications and optimize training pathways in our supply chain.

COVID-19 has delayed the ability to perform a clinical trial associated with an SP colorectal procedure. We placed three Ion systems in the quarter. Ion system placements were also impacted by COVID-19. Ion system placements procedures and related information is excluded from our overall systems and procedure counts. Our rollout of Ion will continue to be measured, while we optimize training pathways in our supply chain.

The completion of the PRECISE study is delayed due to COVID-19, and we cannot predict when the PRECISE study -- the PRECISE clinical study will be completed. Outside the US, we placed 72 systems in the second quarter compared with 80 in the second quarter of 2019 and 55 systems last quarter. Current quarter system placements included 18 into Europe, 18 into Japan and 21 into China, compared with 30 into Europe, 24 into Japan and eight into China in the second quarter of 2019.

Moving on to gross margin and operating expenses. Pro forma gross margin for the second quarter 2020 was 62.4% compared with 71.3% for the second quarter of 2019 and 69.7% last quarter. The decrease compared with the second quarter of 2019 and last quarter primarily reflects period costs associated with abnormally low production, the Customer Relief Program and higher excess and obsolete inventory charges, partially offset by higher system ASPs, reflecting a favorable geographic mix.

Second quarter inventory charges were approximately $27 million, primarily reflecting last generation system, vision and instrument products, which as a result of decreased demand, we are now able to fulfill customer needs with newer, more capable products. As revenues were pressured by COVID-19, production levels may operate at below normal

levels, which may result in higher labor costs and under absorbed overhead and reduced product margins.

Pro forma operating expenses increased 3% compared with the second quarter of 2019 and decreased 11% compared with last quarter. Spending in the second quarter reflected curtailment of costs associated with the impact of COVID-19, particularly training, marketing events and travel and related expenses, partially offset by costs associated with employee relief programs and other direct costs of COVID-19.

Spending during this period of the pandemic will be as follows. We will work to ensure our employee safety and well-being, including investing in PP&E and employee programs. We will continue to support our customers. We will continue to invest in innovation focused on the quadruple aim. We will invest in manufacturing in our supply chain to ensure supply for our customers. We will ensure that we are prepared for periods when the spread of COVID-19 is contained.

Certain costs will be lower as the underlying activities are restricted by COVID-19, including travel and related expenses, clinical trials, surgeon training and marketing events. We will eliminate spending that is ineffective due to COVID-19, like surgeon and hospital events. We will reduce the hiring and volume-related roles like sales reps and manufacturing employees as appropriate.

We continue to believe that we have a unique opportunity to expand the benefits of computer-aided surgery and acute interventions around the world, and we'll continue to invest in the business for the long term. Our pro forma effective tax rate for the second quarter was 36.9% compared with our expectations of 20% to 21%, reflecting a $37 million, or $0.31 per diluted share charge associated with the conclusion of a tax case between an independent third-party and the IRS related to charging foreign subsidiaries for share-based compensation.

Our actual tax rate will fluctuate with changes in geographic mix of income, changes in taxation made by local authorities and with the impact of one-time items. Our second quarter 2020 pro forma net income was $132 million, or $1.11 per share, compared with $388 million, or $3.25 per share for the second quarter of 2019, and $323 or $2.69 per share last quarter.

I will now summarize our GAAP results. GAAP net income was $68 million, or $0.57 per share for the second quarter of 2020, compared with GAAP net income of $318 million, or $2.67 per share for the second quarter of 2019, and GAAP net income of $314 million, or $2.62 per share for the last quarter.

The adjustments between pro forma and GAAP net income are outlined and quantified on our website and include excess tax benefits associated with employee stock awards, employee stock-based compensation and IP charges, amortization of intangibles and acquisition-related items and legal settlements.

We ended the quarter with cash and investments of $6.1 billion compared with $5.9 billion at March 31, 2020. Cash generated from operations was partially offset by investments in working capital and our infrastructure. We did not repurchase any shares in the quarter.

Our current thoughts on capital deployment are in the following order. We recognize the hardship that COVID places on our customers, and we will work with customers to ease the burden of lower da Vinci utilization, including providing customers with more flexible financing. We will ensure -- secure supply chain and build appropriate levels of inventory to ensure customer supply, particularly as procedures resume. We will invest in securing our customers. We will continue our market -- our open-market repurchase program consistent with our prior practice.

And with that, I'd like to turn it over to Philip [ph], who will go over our procedure performance.

Phillip Kim {BIO 5762418 <GO>}

Thank you, Marshall.

Our overall second quarter procedure decrease was approximately 19% compared to growth of 17% during the second quarter of 2019 and 10% last quarter. Our Q2 procedure decrease was driven by a 24% decrease in US procedures and a 7% decrease in OUS markets.

On a worldwide basis, procedures in the quarter troughed in April, and continue to recover throughout the quarter. Although worldwide procedure run rates trended closer to pre-COVID levels in June, we caution investors from assuming this trend continues, given the dynamics discussed earlier in the call. In US, procedure run rates also trended closer to pre-COVID levels in June. However, future procedure performance may fluctuate as customers in states like Texas, Florida and California encounter increased COVID cases.

From a procedure standpoint during the end of Q2, we saw a broad recovery in most procedures, including procedures that had the biggest decline at the end of Q1, such as bariatrics, hernia and benign gynecology. Within the US, there were geographic differences between states that were hit harder by COVID and those that were not. For example, during the quarter, Florida recovered to pre-COVID levels on a run rate basis while New York did not. State-specific containment strategies impacted procedure growth and the timing of COVID outbreaks will play a role in driving geographic differences.

Outside of the US, procedure growth in Asia was strong. As shown in the chart on our Investor Relations website, China performance was strong, but we would caution investors not to use China as a proxy for our global recovery. Japan growth remained strong at over 30% in Q2, and South Korea also grew in the quarter. Western Europe saw broad declines with the exception of Germany, which continued to grow in Q2, albeit at a slower rate.

We provide these data points to inform investors of the procedure dynamics in the second quarter. Given the uncertain scope and duration of the COVID pandemic and uncertain timing of global recovery and economic normalization, we continue to believe that Q2 procedure results aren't indicative of forward trends.

That concludes our prepared remarks. We will now open the call to your questions.

Questions And Answers

Operator

(Operator Instructions) And first question will come from line of David Lewis with Morgan Stanley. Please go ahead.

Q - David Lewis {BIO 15161699 <GO>}

Good afternoon. Can you hear me okay?

A - Gary S. Guthart {BIO 3429541 <GO>}

Hi, David. Yes.

Q - David Lewis {BIO 15161699 <GO>}

Oh, great. Thanks. A little choppy there. So a couple of quick questions for me, Gary, for you. Obviously, I think the focus on the call is going to be on the extended instruments program. So maybe one for you, Gary, which is, look, in most technology industries, we democratize technology sort of lower price to drive the TAM. I'm sure you've extensively studied your customer elasticity. And so Marshall talked about a 7% drop in I&A revenue. Can you just give us any sense of a framework around how to think about improvement in utilization based on these cost improvements? And then also for you, given your competitors, you've seen J&J, Medtronic timelines slip. I think some investors are going to say, why take this kind of move now when the competitive landscape is getting easier. And then I had a quick follow-up for Marshall.

A - Gary S. Guthart {BIO 3429541 <GO>}

Yeah. Thank you. I appreciate the question. On the first question of, do we think that it changes the volume of procedures that might be accessed by our technology, the answer to that is yes. I think the real question will be timeline. A little bit hard to predict the timeline in the near-term just because I think a lot of it will have to do with COVID and recoveries. So that will kind of blur the speed with which it happens. But if you look out over a couple of years, we clearly think that customers want to use our products, they want to use them broadly in different procedure domains like general surgery, but also broadly regionally. And to the extent that we can help them with economics, we think they have a preference to use our products and we think that will help. That's why we did it.

On question two on timeline, there -- we've been working at it for some time. These changes and manufacturing process improvements have taken years to get right. I think

being a little too fancy in the timeline doesn't help the company or our customers. We think that it will be appreciated that we've done it. It will be appreciated that we've done it now. And over time, I think we'll look back on it and be happy that we've bought it as expeditiously as we could.

Q - David Lewis {BIO 15161699 <GO>}

Okay. Very helpful. And then Marshall for you, I appreciate the commentary on 2019 on revenue. I apologize if I missed it. The 7% or $170-ish million type of revenue impact, can you give us a sense of what the gross margin impact, gross or EBIT impact? Maybe gross would be more helpful on 2019. Just trying to get a sense of the gross margin mix shift into '21 on this I&A extended use change. Thanks so much.

A - Marshall L. Mohr {BIO 5782298 <GO>}

Sure. The margin on the products will be relatively consistent with current margin, so the impact is nominal in terms of 2019. It's a slight down only because you have less instrument and accessory revenue. And from a mix perspective, you wind up with more systems revenue. Systems revenues have lower margins, but the individual margins on the instruments are not that different.

Operator

Our next question will be from the line of Tycho Peterson with J.P. Morgan. Please go ahead.

Q - Tycho Peterson {BIO 4279327 <GO>}

Thanks. Gary, I'll start with a question on the capital side. If I go back to last quarter, you obviously talked about using the $6 million on the balance sheet to place more systems, operating leases to go down. So, can you maybe just talk a little bit about that dynamic? What you're hearing from customers, particular in the US on operating leases? And to Dave's point before, with your competitors delayed a little bit, does that change (inaudible) for pushing operating leases in this current environment?

A - Gary S. Guthart {BIO 3429541 <GO>}

Yeah. So just standing back to capital, it's really variable regionally. So where -- they are not strongly affected by COVID or they are recovering strongly, then capital rotates forward again. You saw that in China. And there, we feel good about leasing systems or selling systems. In China, they buy them. They don't lease them. But in other markets where they are interested in leasing, we're happy to do that.

In regions that are being disrupted by COVID, where the flow of patients is changing because of either delays, elective surgery or delays in diagnostic pipelines, there they have capacity on the existing installed base. They may want to move those systems. They may want to upgrade them. But in general, what we've seen and we've seen this in years past, act one, as an operator of the hospital is to use your existing capacity before expanding it. And there, I don't think leasing is the major issue. I think the real issue is them getting back to surgery and getting ready to the extent that they have demand,

leasing helps us. So, I think it's kind of secondary to recovery from COVID in the US primarily.

Q - Tycho Peterson {BIO 4279327 <GO>}

And then on the procedure recovery, just thinking about working through the backlog of patients. Is there any (inaudible) more patients going into laparoscopic (inaudible) and others in robotics driven mediation [ph] therapy. I'm just curious about how you think about alternatives to robotics given the backlog today?

A - Gary S. Guthart {BIO 3429541 <GO>}

Yeah. We get asked that question periodically. I don't see a philosophical shift by heads of perioperative services to try to shift share in response to COVID. In a really hard-hit area, if they're doing everything they can, and the only thing they have available is something other than MIS, they might go that way. I don't think that's their primary objective of the health system and very quickly, they want to return to what they believe is offering the patient the best -- the best outcome. Looking in the evidence, we don't see any evidence of share shifts at this time. That's not to say there aren't there. It's just that nothing has really come up and what we do see is as much positive for robotics as anything else.

Q - Tycho Peterson {BIO 4279327 <GO>}

Okay. I will leave it at that. Thanks.

A - Gary S. Guthart {BIO 3429541 <GO>}

Thanks, Tycho.

Operator

Our next question will be from Bob Hopkins with Bank of America. Please go ahead.

Q - Bob Hopkins {BIO 2150525 <GO>}

Great. Thank you. Can you hear me okay?

A - Gary S. Guthart {BIO 3429541 <GO>}

Yes.

Q - Bob Hopkins {BIO 2150525 <GO>}

Great. Hi, Gary. Thank you for taking the questions. First one for me. I'm just trying to understand, hospital systems' ability to kind of manage through this COVID increase in cases that we're seeing here of late. So I'm just curious, is the -- has that increase in the United States in particular been disruptive to surgical volumes or things held steady despite the uptick in cases?

A - Gary S. Guthart {BIO 3429541 <GO>}

We've seen -- it really depends regionally. So, I guess what we've seen is variance regionally. In hard hit areas, we'll see the implementation of deferrals. Again, in other places that had kind of round one and it's starting to creep back in, they are assuming to manage it concurrently a little bit better. Netting it out, the first few weeks in July looks really wavy, hard to call the good trends. Certainly would not call it a recovery in July and the United States.

Q - Bob Hopkins {BIO 2150525 <GO>}

Yeah, yeah. Okay. I was specifically asking about the US, but it sounds like your response was related to the US, too.

A - Gary S. Guthart {BIO 3429541 <GO>}

Yeah. It's certainly true in the US.

Q - Bob Hopkins {BIO 2150525 <GO>}

Okay. And then the second question I had was just on the capital environment. And I know you just made a commentary earlier. But these results, it's not obvious that there was a big negative impact from COVID on capital. But you made a comment about a challenging environment going forward. I'm wondering how much of that is the need to absorb capacity versus the impact on COVID? I'm just wondering, specifically in the US, the willingness to kind of purchase capital in this environment. Just would love an update there. Thank you.

A - Marshall L. Mohr {BIO 5782298 <GO>}

Sure. So, we did see -- as we reached the end of the quarter, we did see additional postponements of purchases and we did hear from hospitals that they were back to evaluating their budget, thinking about what the ramifications of the costs of COVID treatment where, as well as thinking about the longer-term impacts of COVID in terms of a potential recession and impact on their funds. And so I think the quarter was affected. The capital quarter was affected by COVID.

And going forward, you're right, there will be, first, we think the impact of trying to bring back up systems to full utilization. 27% is a pretty steep decline. And we would expect that they will seek to fill that before they go out and buy more capital, particularly when they're already strained on the financial side. So, I think we started to see it this quarter and I think we're going to continue to see pressures on capital spend.

Q - Bob Hopkins {BIO 2150525 <GO>}

Great. Thank you very much.

Operator

Our next question will be from the line of Larry Biegelsen with Wells Fargo. Please go ahead.

Q - Larry Biegelsen {BIO 7539249 <GO>}

Good afternoon. Thanks for taking the questions. One on capital. One on the regulatory environment. Gary, obviously, systems shipped greatly exceeded Street expectations this quarter. Can you talk about any new programs you've introduced to support new placement? We heard you talk this quarter about the loaner program? Are there any commitment associated with that? And are usage-based agreements increasing? And as I said, I had one follow-up on the regulatory environment.

A - Gary S. Guthart {BIO 3429541 <GO>}

Sure. On that -- on the systems shipped in the quarter, I'll start the answer and I will ask Marshall to jump in and provide a little additional color. I think a lot of what we saw in Q2 in the US was around momentum. Capital pipelines are multi-month engagements for our sales teams and for our customers. They have long-term commitments. They're fairly far down the pipeline. And in some cases, I think they know they want to do this long term and they went ahead and closed. Outside the US, we had strength because you're starting to see procedure recoveries and they're looking to build capacity for additional procedures. With regard to -- with a particular sales program or the introduction of a loaner program and so on that really drove the number, I would not guide you that way. I don't really think that's true.

But Marshall, why don't you step in?

A - Marshall L. Mohr {BIO 5782298 <GO>}

I think you characterized it right. I don't think there was any particular program that drove it. And I think it really does reflect momentum. Gary alluded to a couple of larger IDN deals getting done. Those were months, if not a year in the making. And so it takes time to get them closed out when you're getting close. Even though there is a COVID virus, they went ahead and we do see strength outside the US, particularly in Asia, where COVID has started to recover.

Q - Larry Biegelsen {BIO 7539249 <GO>}

Thanks, Marshall. And just for my follow-up, Gary, you talked about changes to the regulatory environment. Obviously, we all heard J&J said -- saying that they're not going to be filing a 510(k) for their robot in the US. I mean, what are you seeing, Gary, at the FDA? Do you think future surgical robots will be like de novo 510(k)s, PMAs? I don't -- I obviously don't expect you to speak for J&J. But what can you talk about generally on surgical robots?

A - Gary S. Guthart {BIO 3429541 <GO>}

Over the last few years, we've seen an increase in clinical data requirements and evidence generation per new platform, as we come out and we've been talking to you about that over the last several years. With regard to introducing new platforms, us or anybody else, I think the pathway depends on the details of the claims what's being claimed, what procedures are being done and details of the predicates being used. And that would guide any of the conversations we would have with FDA or frankly, our competitors would have. So, I really can't call out what direction it will go for everybody. We do see the

discussions being pretty rational, and they just have required additional data sets as time goes on and nothing -- nothing we've heard from the last couple of weeks of earnings calls has kind of changed our perspective on what we've seen.

Q - Larry Biegelsen {BIO 7539249 <GO>}

Thanks so much.

Operator

Our next question will go to Larry Keusch with Raymond James. Please go ahead.

Q - Larry Keusch {BIO 1504587 <GO>}

Thanks. Good afternoon. Gary, I'm just curious about how you were able to manage your internal R&D development projects throughout COVID. And I guess really the question is, were you able to keep things going or did you see setbacks as well? I mean, I know you talked about the PRECISE trial again, but I'm really thinking sort of your internal development projects.

A - Gary S. Guthart {BIO 3429541 <GO>}

I think we've seen both heroic efforts on the part of our teams. We are blessed by having medical office inside the company and surgeons who -- and medical people who work for the company directly. So, we implemented protocols that allowed us to stay at the leading edge of where safety protocols ought to be for infectious disease and do our best to be able to keep making work, making progress. Our engineering teams have been really creative and thoughtful about getting work done. So, we have seen some delays for sure. I wish I would say otherwise. But it's just a reality.

That said, I think the teams have thought pretty hard to keep our programs progressing and to not just accept slips because COVID exists. Where we are -- where those things are a little bit out of our control, tend to be on things that are in clinical trials as you mentioned. There, you're going back and forth between hospital institution on the front lines. They are using -- deploying their resources in ways that are important to them to manage COVID. We fully understand that. So there, sometimes it's really us in a support mode. Where we can control it, we can control our environment. We can relay on our spaces, our labs and so on, and we can make a little more progress. So, we see some slips but we also see great effort to manage the slips.

Q - Larry Keusch {BIO 1504587 <GO>}

Okay. Terrific. And then the other question is, certainly, there is a sense out there that COVID will sort of accelerate trend that we've already been seeing in a move to some sort of ambulatory surgical setting. Just curious, in the last quarter's call, you sort of mentioned that, that Intuitive organization was ready be helpful in any way and certainly sound like what was implied if robots need to be moved to either ASCs or other care areas that you'd be prepared to do it. Did you actually see any of that occur? And do you think that there is going to be an accelerated trend to move things that you can into non-acute care settings?

A - Gary S. Guthart {BIO 3429541 <GO>}

I'm going to ask Marshall to answer the first part of that question around, that we've seen acceleration in the datasets. And I'll answer the second part of the question around what do we think might happen going forward.

So, Marshall, if you would jump in on the -- what are we seeing so far?

A - Marshall L. Mohr {BIO 5782298 <GO>}

In terms of ASCs, again, ASC is a -- the number of da Vinci type procedures, procedures that da Vinci addresses in ASCs is actually not all that significant, which you really -- if you're talking about HOPDs or ASCs that are owned by -- that are owned by hospital IDNs, then we have a large presence and we are addressing procedures that are presented there. We haven't seen -- I haven't, I'm not aware of movements of a large patient quantities to ASCs during this period. I think hospitals are struggling to meet all needs in terms of COVID. So, I don't think I have anything else to add there.

A - Gary S. Guthart {BIO 3429541 <GO>}

Yeah, I'll jump in on my side. I think that surgery in those environments, what actually happens in the operating room is well understood in robotics and our robotics can play a real role there. What really determines whether some things in a ambulatory setting, a hospital-owned outpatient department setting or inside the hospital and booked as the same-day surgery, the differences there are largely driven by reimbursement and reimbursement policy. To the extent that reimbursement policy stays as it is, then I don't think you'll see a huge move of the kind of procedures that Intuitive does into the ASCs.

But if reimbursement policy were to change in the future, then we'll change with it and go there. So, there is a lot of same-day surgery or outpatient surgery that's done on da Vinci devices. Where they live has a lot to do with the reimbursement. So for us, it's where does it make sense to be performed logistically, where does it make sense to be performed from a reimbursement perspective and then do they have the right tools, technologies and training? And I think we can adjust to that over time.

Q - Larry Keusch {BIO 1504587 <GO>}

Okay. Great. Thank you.

Operator

Next, we'll go to the line of Amit Hazan with Goldman Sachs. Please go ahead.

Q - Amit Hazan {BIO 6327168 <GO>}

Oh, thanks. Hey. Good afternoon. Just a couple quick ones. On the da Vinci SP, if I heard your comments right about Korea utilization being higher than Xi, that was a little bit surprising. I'm just curious if you can give some color behind that and whether that suggests for you that the types of procedures being done on SP are kind of more on

lower acuity side of the spectrum and whether that kind of paved for you how you might be marketing the product here as it evolves?

A - Gary S. Guthart {BIO 3429541 <GO>}

Yeah. In Korea, the nice thing is that the regulatory clearance allows broad clinical application. As a result, they can do procedures in urology, in thoracic, in gynecology and head and neck. And they're also looking at procedures in the breast. There, I think it's less about low acuity and I think they're really exploring where does a single incision or a natural orifice approach really drive clinical value. The surgeons are, I think thoughtful and innovative here. And that's exciting to us. In the US, we need to run trials and get additional data as we've said before for colorectal applications and for some of the other things that we have in the pipeline. So that will take us some time.

So, we look at Korea to say, okay, what does demand look like when not constrained by the regulatory setting? The nice utilization or high throughput sort of tells us two things. One is there is a real interest in exploring the hypothesis that this creates better outcomes. We can also look at the data there and start to see where it does indeed, that's exciting. The second thing is, it puts the product through the tests of high throughput, high turnaround. Is it well-designed in that setting, and can they use it as much? And that's been powerful for learning, but also encouraging for us as to the maturity of the product even at this early stage. So that's how we're looking at Korea and to help inform our regulatory strategy in other parts of the world.

Q - Amit Hazan {BIO 6327168 <GO>}

And then my follow-up would be on just new doctor training. That was obviously still quite strong for you pre-COVID here in the US, and it's obviously been a key element for your procedure growth looking forward. So just qualitatively, are you able to just give us a sense of the impact on training that you saw in the quarter and how you're thinking about the rest of the year? Just the levels of normal, even like you did for procedure would be super helpful to just get a sense of where you are with being able to train new doctors?

A - Gary S. Guthart {BIO 3429541 <GO>}

Yeah, I'll start and Marshall will help you -- I will ask you to jump in and add some color. It's clearly challenged. And one of the things that we're working on. First, wide upfront, particularly in the United States, doctors are focused on other things and travel, which some training requires is strained.

So for us, two things have been going on. One of them is to see if we can forward deploy our training assets to make travel easier or extremely convenient to travel by car, for example, rather than by plane or use of digital tools and cloud technologies to be able to get access to some of the materials that they might use. I'm actually encouraged on that front. I think we have some investments we've made over the years that we can leverage to help and we're seeing the beginnings of that. So, I think that side looks good. That said, training requires -- demand generation requires interactions with our sales teams in addition to training, once they get going. So it's substantially below prior levels. We're starting to see the beginnings of it coming back.

But I'll let Marshall give you a little better color there.

A - Marshall L. Mohr {BIO 5782298 <GO>}

Yeah. It has been below our historical levels and the importance of it varies depending on the geography as well. So, we are in, let's say, in Japan, where you have newer procedures that you're trying to adopt, training becomes a more important element. And let's say, in the United States where people can otherwise be trained in their institutions or that we're talking about mature procedures we are proctoring and so forth is more readily available. So, I think in United States, the contribution of new surgeons is much lower than, let's say, in a geography like Japan. And so we did see quite a drop-off in training earlier in the United States because of reluctance to travel and other COVID related reasons. And as Gary said, we're finding other ways to perform that training and it could have some impact on us. But again, it's not as big a contributor in the United States as our existing surgeons.

Q - Amit Hazan {BIO 6327168 <GO>}

Thank you.

Operator

Next, we will go to the line of Rick Wise with Stifel. Please go ahead.

Q - Rick Wise {BIO 1490589 <GO>}

Good afternoon, Gary and Marshall. I was reflecting again about the delayed J&J program and about, I think you said it or Marshall said it, Intuitive's unique opportunity to invest. Help us think about this. I have to imagine that in some way, perhaps many ways, Intuitive has been actively aggressively thinking about the challenge, preparing for near term and long term for the possibility of more competition. That challenge would seem to be meaningfully delayed for the moment.

Does this offer you in any way an opportunity to accelerate the pipeline or accelerate spending in some kind of way? Does this window present an opportunity? It does present you some kind of unique opportunity to invest in. You are going to do something different now than you would have, if it had been more imminent.

A - Gary S. Guthart {BIO 3429541 <GO>}

Thanks, Rick. For us, we've really focused on being tightly focused on really making measurable improvements to the quad aim. Really looking -- forward looking through the windshield rather than in the side mirrors as to what we think is important. I guess what I'd say is the greatest limitation for us so far has not been opportunity, I think to do interesting things. So, there is an enormous amount of opportunity out there to make improvements and there is enormous technology opportunity.

I think the biggest challenge and the rate limiting step for us has really been to continue to deploy our programs with excellence. And so that's been the rate limiting step on

growth. I think that other companies out there are investing in things that makes sense, that are interesting. I think the vision about where the world might be in 10 years or 15 years is not a complicated one. I think it's reasonably shared. And I think what will differentiate Intuitive and other companies is really the ability to deliver these complex technologies at a very high-quality level and in ways that customers can really use access to resources. So, I look around at what's going on outside and I think they are engaging some of the -- both opportunities that are out there in the world and some of the challenges of doing this well and delivering it. So for us it's, I guess, I didn't wake up this week and think that the world has changed because of somebody else's conference call.

Q - Rick Wise {BIO 1490589 <GO>}

Okay. And just a second question from me. On Monday, we presented 100 plus robotic surgeon survey. And of those who said they had wanted to buy da Vinci, 40% said that they were -- they had made a decision to now postpone. Not a big shock. And you're corroborating that, of course. But how are you thinking? How would you have us think about that postponed volumes? Are you concerned at all that these orders are lost and could we see a sharp resurgence in capital? As normal demand continues, you open new accounts, new procedures. And on top of that, we see these postponed volumes. Is that the right way to think about it? Thanks, Gary.

A - Gary S. Guthart {BIO 3429541 <GO>}

Okay. I think there's two drivers of additional capital. One of them is the need for additional capacity driven by surgeon and patient demand for da Vinci procedures. To the extent that, that demand is suppressed because of COVID, fears about COVID or delays in diagnostic pipelines, that will pressure the capital pipeline. That varies regionally. So where COVID is well managed, we see not unusual types of sales activities. Where COVID is very intense, not surprisingly, they were focused on other things.

The second thing that can drive capital demand is new features, product that they want access to because they have over technology. And in that case, if they have the attention span to pursue it in the capital or leasing dollars to do something about it, then we can continue to make progress. The prior one, the issue of absorbing existing demand in the field, procedure demand in the field will be the dominant one in my opinion in the next few months. How long that lasts has a lot to do with COVID, and really none of us know how long that will be. So, we will be ready. We'll react. We are in a strong position from an organization point of view. I think we are able to run the business for the long term. And so we'll do our best in that period. And we'll see it as it plays out.

Q - Rick Wise {BIO 1490589 <GO>}

I appreciate that. Thanks.

A - Gary S. Guthart {BIO 3429541 <GO>}

So that was our -- that was our last question. Thank you.

In closing, we continue to believe there is a substantial and durable opportunity to fundamentally improve surgery and acute interventions. Our teams continue to work

closely with hospitals, physicians and care teams in pursuit of our customers have termed their quadruple aim: better, more predictable patient outcomes, better experiences for patients, better experiences for their care teams and, ultimately, a lower total cost to treat -- of care. We believe value creation in surgery and acute care is foundationally human. It flows from respect for and understanding of patients and care teams, their needs and their environment.

Thank you for your support on this extraordinary journey. We look forward to talking with you again in three months.

Operator

Ladies and gentlemen, that will conclude our conference for today. Thank you for your participation and for using the AT&T Teleconference. You may now disconnect.