Alere

Monday, August 4th, 2014 @ 8:30 AM ET

2nd Quarter Earnings Call

Jon Russell:

Good morning and welcome to the Alere conference call to discuss our results for the quarter ended June 30th, 2014.

We are joined today by our Chairman, Gregg Powers, our Interim CEO and President, Namal Nawana, and our CFO, Dave Teitel.

Before we get to that discussion though, I would like to point out that during this conference call we may make forward-looking statements including statements about future organic growth, potential divestitures and anticipated reductions in cost. These statements reflect our current views with respect to future events or financial performance and are based on current assumptions and information currently available. Actual results and the timing of events could differ materially due to the risks and uncertainties described in our Form 10-K, Form 10-Qs and other reports and filings with the SEC. Our Company undertakes no obligation to update forward-looking statements.

Additionally, please note that during this call we may discuss non-GAAP financial measures. For each non-GAAP financial measure discussed, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the differences between the non-GAAP financial measure discussed and the most directly comparable GAAP financial measure is available on the company's website at *www.alere.com/investors*

With that, let me turn the call over to our Chairman, Gregg Powers.

Gregg Powers:

Thanks Jon, and good morning.

It has been a busy quarter for the company, and it is my goal this morning to shed some light on recent developments.

In conjunction with my appointment as Chairman, the Board commissioned a major international consulting firm to conduct a comprehensive strategic review of the company's operations. As part of that process, the Board subsequently accepted the resignation of Ron Zwanziger and appointed Namal Nawana Interim President and CEO.

The review process is ongoing and purposefully comprehensive. We are examining each business unit from the top down to understand its strategic place within the company. Within the business units themselves, we are evaluating each product from the bottom up, calibrating the strength of our technologies, sizing the available market opportunity, and determining the best allocation of resources to drive growth and shareholder value.

Our prior operating strategy resulted in an organization with excessive breadth and profound inefficiencies. It is also clear that prior management had failed to coherently integrate many of its more than one hundred acquisitions. These organizational challenges were compounded by management's prioritization, or more accurately stated – preoccupation, with its Connected Health initiative.

The concepts and technologies surrounding Connected Health are important and relevant. While the vision behind the Connected Health initiative remains a promising one, it is the judgment of the Board, our consultants and new management, that given our scale and desire for sharpened focus, our strategic review process will consider if another owner could derive more value from these assets.

Alere possesses market leading diagnostic technologies and its Professional Diagnostics business should be able to grow at rates equal to, or in excess of, the markets we serve. As you can see from today's results, this is currently not the case. We believe that both near-term and long-term shareholder value can be enhanced materially through focused and disciplined execution within the core business.

Over the last eighteen months, in his role as Chief Operating Officer, Namal has observed numerous opportunities to improve the business. He, however, was not empowered to effect many of the changes necessary to sharpen our focus, drive growth and further enhance our financial performance. This situation has now been corrected.

Since the transition, I have personally spoken with each member of the company's Global Leadership Team and have been impressed by their passionate support for the changes we have made, and those we will make in the near future, along with their commitment to drive the company's performance to levels commensurate with our technologies and market position.

With that said, I will turn the call over to Namal to share his thoughts.

Namal Nawana:

Thanks, Gregg, and good morning everyone.

On today's call I will focus on 3 key areas. Firstly, commenting on results of our second quarter earnings, secondly, discussing progress and further plans associated with our strategic review and re-positioning the company as the global leader in rapid diagnostics and, thirdly, bringing some perspective to our financial outlook and approach going forward.

The 2014 second quarter financial results for Alere are unsatisfactory. Adjusted earnings per share in the quarter of $0.42 are below expectations, and were impacted by several factors, including one-time costs associated with two product recalls, gross margin pressure due to weak results in high margin geographies and increased spending within our Connected Health unit.

The effect of two product recalls contributed to below plan organic revenue growth for the global professional diagnostics business in the quarter as well as depressed gross margins on a one-time basis. Gross margins were also negatively affected by geographic revenue mix, specifically weak U.S. results and a relatively strong quarter in Africa.

Excellent growth in many of our international businesses continued in Q2, but was not sufficient to offset the revenue challenges just mentioned. These international markets will be a continued area of focus and investment going forward and should help drive stronger organic growth overall. Dave will report more details on revenue results shortly.

Adjusted SG&A spend overall was flat sequentially from the 1st quarter. In the second quarter we eliminated approximately $21 million in annualized SG&A costs through restructuring initiatives, however the timing of these changes allowed little benefit to flow through in the quarter. Total operating expense was also adversely impacted by substantially increased spending on the strategic build-out of our Connected Health unit. In fact, investments in Connected Health generated an unfavorable effect on operating income of roughly $10 million in the quarter.

I want to make it clear that we are moving rapidly to improve financial performance in line with a new strategic direction which will center around Alere's core strengths as the global leader in rapid diagnostics and, in particular, in our focus areas of infectious and cardiometabolic disease and toxicology. I anticipate that within the next few months these plans will be fully formed and communicated broadly.

We also remain committed to further streamlining our cost structure. In addition to the approximately $21 million in annualized SG&A costs we removed late in the second quarter, there are multiple initiatives underway to further rationalize our annual cost base in both the near and mid-term.

The combination of weakness in our U.S. respiratory categories, product recalls and our inability to bring select Triage cartridges fully back to market are weighing on our near-term growth prospects in North America. Although we have improved our quality and manufacturing operations substantially in recent times, we recognize that Alere still has substantial opportunity to improve in this domain. As quality issues are fully resolved and automation and consolidation opportunities take hold, this challenge ultimately represents a further major horizon for revenue growth acceleration and operating income margin expansion.

I am confident that these issues are completely resolvable, but it is my approach to deliver outcomes rather than offer promises.

Our investments in Connected Health in recent times have accelerated and are now substantial in terms of both direct costs and organizational energy. As we aggressively re-scope our investment in Connected Health, we are confident that this will directly improve our financial and organizational performance. Some elements of our technology platform related to instrument connectivity will continue to support our core business significantly going forward and these investments will be protected. Other assets in Connected Health will be evaluated for divestiture and, in the very short term, we will limit investment in these activities.

As Gregg has indicated, Alere has both acquired and developed an impressive and broad array of assets over the past decade. However, operating so broadly has caused diffuse resource allocation that has ultimately hindered financial performance. I can report that, through excellent discussions between the Board and new management, we have agreed on a plan to assess the full range of Alere's technology assets against our forward strategic direction. This work will be completed in the coming months. Importantly, certain decisions have already been made in this domain. I can confirm that we will actively divest our health management businesses, looking to complete this before year end. We have no plans to restart the BBI asset spin off at this stage. However, we will look at the right options for each of the component businesses that were put together through that process. We will also look to stop investment against and potentially divest other smaller non-core assets in various fields of oncology, women's health and veterinary products. It has additionally been agreed that we will cut certain speculative R&D projects, invest more in several others, but in total will bring down overall R&D expenditures. We will focus on the highest impact projects and we are committed to improved R&D focus and productivity.

The strategic review that we are performing in partnership with a major external consulting firm has moved to a new, much more detailed phase. We expect this deep evaluation of our entire portfolio of businesses to be completed before year end, with transparent communication of the conclusions to shareholders shortly afterward.

By committing to a new strategic direction that will better utilize the strengths in our core rapid diagnostics businesses, Alere will position itself to be a strong solutions provider for healthcare globally in the fields of cardiometabolic disease, infectious disease and toxicology. While our recent growth headwinds are real, we expect that these issues will be mitigated, as just discussed, through strategic focus and direct cost measures.

Through renewed focus and investment in our core, we will enhance our competitiveness in growth markets where we enjoy leadership positions already. It is the belief of the Board and new management that this will deliver more predictable, long term, sustainable shareholder value.

And now, let me turn the call over to Dave for a more detailed discussion of our reported financial results for Q2.

Dave Teitel:

Thanks, Namal, and good morning.

Adjusted net revenues for the quarter were $738.3 million compared to $764.6 million in Q2 2013. The effects of foreign currency translation increased Q2 2014 adjusted net revenues by $5.5 million compared to Q2 2013.

Adjusted net product and services revenues from our professional diagnostics segment were $578.4 million in Q2 2014 as compared to $600.2 million in Q2 2013. The decrease in segment revenues relates principally to lower U.S. revenues from our mail order diabetes business which decreased from $56.2 million in Q2 2013 to $33.0 million in Q2 2104, despite an increase in patients served from 455,000 as of the end of Q2 2013 to 778,000 as of the end of Q2 2014, due to the decrease in reimbursement rates that became effective on July 1, 2013. Excluding the impact of the change in U.S. influenza revenues, the impact on revenues from the U.S. meter-based Triage product sales and the impact of the mail order diabetes reimbursement rate reduction, currency adjusted organic growth in our Professional Diagnostics segment was 0.4%. This growth rate reflects a 4.1% decrease in adjusted U.S. revenues, compared to the second quarter of 2013, offset by a 4.3% increase in our international business. The decrease in the U.S. business principally relates to continued lower utilization levels during 2014 than during 2013 and to the impact of product returns in our INR business as a result of the recall initiated in early Q2 which adversely impacted revenues by $3.7 million. International growth in the professional diagnostic segment was highlighted by continued strong performance in both India and Africa, both of which grew by over 20%, offset by weaker performance in Latin America, where a diabetes tender in Brazil in Q2 2013 did not recur in 2014 and a weak dengue season impacted overall revenues in the region. New products contributed favorably to our overall adjusted growth rate, with sales of CD4 products increasing from $4.6 million in Q2 2013 to $7.6 million in Q2 2014 and Epoc sales increasing from $5.5 million to $6.9 million for the same periods.

With respect to other new products, we filed CLIA waiver submission for our Alere i influenza test and our Determine Combo antibody/antigen test and filed for 510k clearance for a strep A test for the Alere i platform during July. Additionally, we have self-certified our Alere Q instrument for CE mark and have submitted our certification package for CE mark to our notified body for the disposable which runs on Alere Q for early infant diagnosis in August.

Net revenues from our Health Information Solutions segment were $125.8 million in Q2 2014 compared to $134.8 million in Q2 2013, reflecting growth in our patient self-testing business from $25.7 million in Q2 2013 to $29.4 million in Q2 2014, offset by decreases in all other areas of this segment as a result of the challenging contracting season for this group in the second half of 2013.

Net product and services revenues from our consumer diagnostics business segment were $27.4 million in Q2 2014 compared to $24.7 million in Q2 2013, reflecting continuing success from our joint venture with Procter & Gamble, driven particularly by the Clearblue Advanced Pregnancy Test with Weeks Estimator in the U.S.

Adjusted gross margin was 48.4% of adjusted net revenue in the second quarter of 2014 compared to 52.8% in the second quarter of 2013. The lower gross margin in the current period principally reflects revenue and cost of sales charges totaling $7.5 million related to the INRatio 2 recall that I discussed earlier and to a second quarter recall of certain Beckman Coulter Triage BNP tests. Additionally, our continued growth outside the U.S. coupled with weak U.S. revenues contributed from a mix perspective to weaker margins in the quarter.

Adjusted selling, general and administrative expenses were $220.0 million or 29.8% of adjusted net revenues in Q2 2014 compared to $222.2 million or 29.1% of adjusted net revenues in Q2 2013. Adjusted research and development expense was $35.0 million, or 4.7% of adjusted net revenues, compared to $37.9 million, or 5.0% of adjusted net revenues, in Q2 2013. During the second quarter, we implemented a workforce reduction which we expect will reduce combined operating expense by $21.3 million annually and which reduced Q2 2014 operating expenses by $2.1 million.

Adjusted interest and other expense was $49.0 million in Q2 2014, compared to $57.7 million in Q2 2013. Adjusted interest expense, net of interest income was $51.1 million in Q2 2014 compared to $55.0 million in Q2 2013.

Our adjusted tax rate was 26% of pretax income compared to 34% in Q2 2013. We expect the tax rate for the balance of the year to be slightly less than 30%.

Our non-GAAP EBITDA for the quarter was $110.2 million, which includes deductions for restructuring charges of $15.8 million, $0.1 million of acquisition related expenses and $11.6 million of costs associated with potential dispositions. Cash flow from operations was $19.3 million, offset by capital expenditures of $26.9 million. Cash flow from operations during the quarter was adversely impacted by the payment of $9.1 million of severance charges associated with a workforce reduction, $6.2 million of payments associated with costs incurred related to planned dispositions and $16.7 million of contingent purchase price payments in excess of acquisition date accruals. Additionally, cash flow from operations for the second quarter reflects the payment of $49.6

million of semiannual interest payments on Senior and Senior Subordinated Notes.

On an LTM basis, our adjusted non-GAAP EBITDA with restructuring, acquisition and other costs added back, was $623.7 million resulting in a net debt to adjusted non-GAAP EBITDA ratio of 5.4 times.

I would now like to turn the call back over to Namal.

Namal Nawana:

Thanks Dave.

Before opening the call up for questions I'd like to provide some commentary on the three-point plan that Alere has been working towards since late 2012.

Point 1 of the plan related to organic growth acceleration. Full year 2013 performance returned Alere to mid single-digit organic growth, mostly driven by focused resource allocation and energy on international markets, but also helped by strength in our infectious disease businesses. In the first half of 2014, softness in our respiratory business as well as overall U.S. market performance and the effect of two recalls has stalled growth. This will not be materially reversed during the second half of 2014, despite solid performance in international markets. Alere's Health Management businesses have suffered revenue losses in early 2014 which, despite some modest recent wins, will persist and dampen overall growth until divestitures of these businesses are complete. As I indicated previously, Alere cannot and will not rely on revenue growth to achieve operating income targets in this calendar year and will revert to further efforts on the cost base. However, this should not be construed as a lack of confidence in our overall growth potential. With improved manufacturing performance, our full portfolio of products back in the market and a more focused approach to our core diagnostic areas, we expect organic revenue growth to resume in 2015.

Point 2 of the plan related to an improved cost base. In 2013, 150 basis points of leverage were achieved versus 2012 despite substantial investment to initiate enterprise infrastructure that was not in place and support quality remediation efforts. In the first half of 2014, progress on the SG&A rate has been hampered by revenue shortfalls but meaningful cost basis improvements were initiated. These were, however, more than fully offset by increased spending in Connected Health. As we look to the second half of the year, the strategic focus shift and new cost initiatives will improve on first half performance and we will seek to deliver on the commitment of a 28% SG&A rate as we exit 2014 and for full year 2015. This will remain in our strategy for financial execution going forward, ensuring a foundation for solid earnings growth.

Point 3 of the plan committed to deleveraging the business and was updated to target 3 times net debt to adjusted cash-basis EBITDA by the end of calendar year 2015. Whilst efforts were made to divest certain assets, including a proposed spin-off of our BBI business and associated units, asset sales have not yet contributed to deleveraging. With the management transition, I have already initiated a new assessment of all technologies in conjunction with the Board and have become actively involved in portfolio management. This will become a part of my personal focus in the coming months in order to fully execute on divestitures now agreed with the Board and to diligently evaluate our full portfolio of assets as discussed earlier. However, we will only move forward with divestitures that support our new strategic direction and in which the value received is attractive. We will, additionally, continue our efforts to increase cash flow from operations through improved focus and execution.

The strategic review currently underway will allow our business to succeed in the critical areas identified in the three-point plan – organic growth, operational excellence and a stronger balance sheet. We are committed to enhancing shareholder value and will take the next few months to refine and consolidate our plans. In the interim, and in the absence of revenue growth as a driver, we will be using the principle levers of strategic focus and further cost measures to deliver solid financial results for the 2nd half of 2014, while remaining committed to extracting improved cash flow from operations and executing on asset divestitures.

A final, critical initiative during the second half of 2014, is rapid improvement in the integrity of our forecasting, through sharpened focus on key profitability drivers, as well as increased accountability within the organization. Enhancements in this area will allow us to confidently resume providing earnings guidance early in 2015.

And now let me open the call up to questions.   Operator?

Q&A

Namal's closing:

In closing, with the support of our Chairman Gregg Powers and the Board to focus on Alere's strengths as the global leader in rapid diagnostics, I personally feel a renewed optimism about the financial and overall outlook for Alere.

We will immediately activate numerous levers to simplify our business further, reduce our cost base and also re-allocate expense to support the future growth of our core businesses. We are the global leader in rapid diagnostics and have highly-differentiated products as well as services in the majority of businesses we will choose to focus on in the future.

Short term revenue headwinds are real. We recognize that, to achieve our goals, further efforts are required to fully remediate product performance, optimize our broad portfolio in support of our strategy and improve execution. Whilst this requires some time and investment, ultimately it will support accelerated growth and operating income margin expansion.

Our underlying core assets are valuable, our competitive positions in key business areas are strong, and our senior leadership team is aligned, energized and capable of meeting the challenges and acting upon the opportunities ahead.

Our desire to better serve our shareholders and customers is, and will continue to be, at the forefront of conversations and actions within our global organization.

Thank you for your support and interest, and have a good day.