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RTIX - Q3 2018 RTI Surgical Inc Earnings Call

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PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the RTI Surgical Q3 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the conference over to your host, Nathan Elwell, Investor Relations. Please go ahead, sir.

Nathan Elwell

Thank you, Casey. Good morning, and thank you for joining on the call to discuss RTI's third quarter 2018 results. On the call today are Camille Farhat, our President and Chief Executive Officer; and Jonathon Singer, our Chief Financial and Administrative Officer. Camille will provide a brief strategic update and discuss the quarter, and then Jon will outline the third quarter financial results. After their comments, the team will be available to take questions.

Before we start, let me make the following disclosure. The earnings and other matters we will be discussing on this conference call will involve statements that are forward looking. These statements are based on our management's current expectations, but they are subject to various risks and uncertainties associated with our lines of business and with the economic environment in general.

Our actual results may vary from any statements concerning our expectations about future events that are made during this call. We make no guarantees as to the accuracy of these statements. Accordingly, we urge you to consider all information about the company and not to place undue reliance on these forward-looking statements.

During the call, we will also present certain financial information on a non-GAAP basis. Management believes that non-GAAP financial measures, taken in conjunction with U.S. GAAP financial measures, provide useful information for both management and investors by excluding certain noncash and other expenses that are not indicative of our core operating results. Management use these non-GAAP measures to compare our performance relative to forecasts and strategic plans to benchmark our performance externally against competitors and for certain compensation decisions. Reconciliations between U.S. GAAP and non-GAAP results are presented in tables accompanying our earnings release, which can be found on the Investor Relations section of our website.

Now I will turn the call over to Camille. Please go ahead.



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Camille I. Farhat - RTI Surgical, Inc. - CEO, President & Director

Thanks, Nathan, and good morning, everyone. We are pleased to report strong third quarter financial results. Before I go into detail on the quarter, I want to take a moment to highlight the significant progress we have made against the 3 pillars of our strategic transformation: to reduce complexity, drive operational excellence and accelerate growth. As a reminder, we sold the CT business and transitioned our own donor recovery agencies to better long-term stewards of these businesses to help increase our focus on customer intimacy and focused innovation in our core tissue and spine platforms.

We initiated aggressive cost-reduction initiatives that resulted in a more competitive cost position and a more attractive platform for growth. We initiated lean manufacturing activities and installed a culture of continuous improvement contributing to an improving environment of predictable execution.

We are reinvigorating our R&D function and innovation pipeline, supported by worldwide product plan for spine and a long-term growth strategy for OEM. We returned the OEM franchise to growth and made progress on our current spine portfolio by launching Fortilink-TS and -L with TETRAfuse technology, which recently won a 2018 Spine Technology Award from Orthopedics this week. We further strengthened our differentiated spine offerings by acquiring Symmetry through Zyga and securing the next-generation stem cell products with ViBone. This is tremendous progress. And with these initiatives now ingrained in our corporate culture, we are producing improved operational and financial performance, and we are increasing our focus on accelerating near-term growth.

With that, let me turn to our third quarter results. As you saw in our release, we produced strong growth in both our spine and OEM franchises during the quarter. We delivered increasing revenues of approximately \$69 million with strong gross margins of 54.5%. Net income improved to \$2.9 million or \$0.04 per fully diluted common share, which includes \$900,000 of net nonrecurring income. Adjusted EBITDA increased to approximately \$9 million for the quarter or 13% of revenues driven by gross margin expansion. These improvements stemmed from our efforts to reduce complexity and increase operational excellence initiated during 2017, and we are partially offset by increased operating expenses focused on accelerating growth.

For example, we had under invested in R&D in recent years and have now implemented the planned increases through R&D spending to rebuild our product pipeline. Finally, with one quarter left in the year, we have also narrowed our fiscal 2018 outlook, which Jon will discuss later.

Our OEM franchise continued its strong performance this quarter. Our team has done a tremendous job of getting closer to our customers, better understanding their needs and the direction of the market and focusing our operations accordingly to drive growth. The changes we have implemented are really paying off and our credit to all involved.

We are proud of the persistent efforts from our team that produced excellent results for our spine franchise, aided by the continued market acceptance of Fortilink and continued progress with Symmetry. As we have previously stated, the FDA had determined that our map3 product would be subject to more rigorous requirements applicable to biological drug products. We are very proud of the collaborative efforts our teams dedicated to addressing the FDA's observations.

After evaluating the full impact of the FDA's determination to assess what more is needed to upgrade our systems and processes, we decided the efforts needed were significant and ultimately not a viable investment. As such, we decided to stop providing map3 effective the end of this last month, October, but we'll continue to provide a full suite of high-quality orthobiologic products, including ViBone.

In August, we added ViBone to our portfolio, and our commercial team has done a great work introducing it to our customers over the past few weeks. ViBone is a promising next-generation cellular bone matrix product with a high potential to meet the diverse needs of surgeons and improve patient outcomes in spine and orthopedic procedures. During the quarter, we planned and started to implement the transition from map3 to ViBone and other products in our comprehensive orthobiologic portfolio.

In line with that comment, in its first full quarter since launch, Fortilink has been an excellent addition to our growing series of interbody fusion devices, featuring our proprietary TETRAfuse 3D technology. The Zyga team also continues to execute and contribute as planned with both



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procedural and revenue performance for Symmetry on track for the year. Overall, the differentiated products we have recently added are strengthening our robust spine portfolio, and we are confident we are well positioned to continue this expansion going forward.

And finally, based on our successes with the first 2 elements of our transformation, I am focused primarily on accelerating growth by strengthening our R&D pipeline, developing products road maps for each of our business lines and pursuing M&A activity.

In conclusion, and as we have stated in January, 2018 is a year of focused execution for RTI. We firmly believe we have demonstrated that we have the right strategy, and we are delivering the transformation. We produced solid third quarter serves as our efforts towards operational excellence continue to pay off, and our core franchises in both OEM and spine achieved excellent growth. We are confident that our strategic transformation continues to build its momentum. Our increased investment in both M&A and R&D activity supports our increasing focus on the acceleration of growth.

With that said, I will hand over to Jon to outline our financial performance.

Jonathon M. Singer - RTI Surgical, Inc. - Chief Financial & Administrative Officer and Corporate Secretary

Thank you, Camille. Jumping right in at the top, RTI's worldwide revenues for the third quarter of 2018 were \$69.1 million, an increase of \$2.4 million or 3.6% when compared with \$66.7 million during the same period for the prior year. Third quarter revenues were driven by the 14.4% growth in the spine franchise with strong demand from Fortilink and Symmetry and continued solid contribution from OEM.

Gross profit for the third quarter of 2018 was \$37.7 million, an increase of \$4.1 million or 12.4% compared to \$33.5 million for the comparable prior year period. Gross margins were 54.5% of revenue compared with 50.3% of revenues in the third quarter of 2017. The 400 basis point improvement in margin from last year is partially related to mix in the spine portfolio and predominantly related to the operational excellence initiatives we've taken in our tissue processing operations. We continue to be on track to drive cost reductions of approximately \$13 million in 2018.

Marketing, general and administrative expenses were \$29.7 million for the third quarter of 2018, an increase of \$2 million or 7.2% compared to \$27.7 million in 2017. The increase is predominantly driven by commissions on the growth in spine and the addition of Zyga acquired at the start of 2018.

Research and development expenses were \$3.6 million in the third quarter of 2018 compared to \$2.8 million in 2017. The increase in R&D is driven by the acceleration -- the planned acceleration of organic growth investment. During the third quarter of 2018, we incurred nonrecurring pretax charges to support the ongoing strategic transformation of the business. The company incurred \$1.9 million of acquisition and integration cost related to investments in our objective of accelerating growth through the ongoing pursuit of M&A activity. The company incurred \$0.8 million of severance and restructuring charges to complete the rationalization of the international infrastructure and transitioned distribution to a third-party logistic partner.

Finally, the company recognized a \$3 million gain from a cash contingency consideration related to the release of escrow funds held at the close of the cardiothoracic closure sale. During the third quarter of 2017, the company incurred \$2.8 million of nonrecurring charges, primarily to support executive leadership transitions.

Also, and hopefully I'll be mentioning this for the last time, during the third quarter of 2017, RTI completed the sale, substantially all the assets, of its cardiothoracic closure business for a total consideration of \$54 million plus an additional \$6 million in contingent cash consideration. In conjunction with the sale, the company recognized a gain of \$34.1 million or \$18.2 million after tax.

Adjusted earnings before interest, taxes, depreciation and amortization, also known as adjusted EBITDA, for the third quarter of 2018 was \$9.1 million or 13% of revenue compared with \$8.1 million or 12% of revenue for the third quarter of 2017. The increase in adjusted EBITDA is primarily driven by the reduction in operating expenses associated with the efforts to reduce complexity and increase operational excellence implemented over the last 18 months.

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Net income applicable to common shares was \$2.9 million or \$0.04 per fully diluted common share in the third quarter of 2018 compared to net income applicable to common shares of \$16.5 million or \$0.23 per fully diluted common shares in the third quarter of 2017.

As outlined in the reconciliation tables presented in our earnings release, excluding the impact of the various nonrecurring charges, adjusted net income applicable to common shares was \$2 million or \$0.03 per fully diluted common share in the third quarter of 2018.

Briefly looking at liquidity. Our cash position at the end of third quarter was \$10 million, and working capital totaled \$120.3 million. We had approximately \$50 million outstanding on our ABL at the end of the quarter.

Turning to guidance. Based upon our current business outlook, we are narrowing in our financial guidance for 2018 originally issued on January 5, 2018. We now expect full year revenue of approximately \$280 million, and we now expect full year EBITDA to be in the range of \$32 million to \$35 million. The company noted the following assumptions are included in its guidance: relatively stable market conditions in regulatory environment; continued positive revenue contribution from the acquisition of Zyga, announced January 4; ongoing positive impact of efforts to reduce complexity and implement operational excellence; and the successful ongoing transition of map3 to ViBone or an alternative RTI by orthobiologic product during November, December this year.

With that, operator, I would like to open the line to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from Dave Turkaly with JMP Securities.

David Louis Turkaly - JMP Securities LLC, Research Division - MD and Senior Research Analyst

Just you highlighted that map3 to ViBone transition. I guess, I'd love an update, any color as to how that's going and how that's being received. And I know it's early but...

Camille I. Farhat - RTI Surgical, Inc. - CEO, President & Director

David, it's Camille. So like I said, yesterday really was the last day that we were shipping map3. As you can expect most customers are going to stick to what they're familiar with. The initial trials that people have had in the last few weeks, where we have introduced ViBone to them, has been relatively positive. And again, it's a little bit early to comment on that. We'll know more in the coming months. We are investing and committing to continuing to generate additional clinical data around ViBone. As you know, that is also a recent product on the market. And we expect to validate what we have seen in the bench test that it would be a very competitive product and should be well received in the market.

David Louis Turkaly - JMP Securities LLC, Research Division - MD and Senior Research Analyst

And then on spine, I know you mentioned Fortilink and Symmetry. I guess, if you kind of look at those 2, contribution-wise, any color or any additional detail? I mean, how big do you think those products can be or are today? And maybe like if you're looking out to next year, could they provide a tailwind for your spine growth maybe into next year?

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Jonathon M. Singer - RTI Surgical, Inc. - Chief Financial & Administrative Officer and Corporate Secretary

When you say tailwind, are you saying from a quarter or year-over-year comparison, no. Both of these are early in the introduction to the marketplace. And so the Symmetry product, so we did about \$1.2 million in the quarter. The product has been consistently growing at about 20% year-over-year. The market is growing, we believe, at 20% year-over-year. And we believe, based upon the clinical data that we're getting through the continued study, that we have a superior product on the market. Our -- we've got over 70% fusion rate with the product. And anybody that looks at spine products knows that fusion over fixation is obviously preferred. And then also what we're finding in the study is consistent reduction in pain and reduction in opioid usage. So all of these study benefits are providing support for the ongoing growth of Symmetry, and we're very optimistic that we can continue to grow that business well beyond the contribution it has today. We estimate that market somewhere around \$120 million. And we believe, as we said, that market is growing at 20% a year. On the Fortilink, the interbody market, very similar. The interbody market is over \$1 billion, and we're seeing tremendous acceptance among our physicians for the product. The texture of the TETRAfuse product enables blood flow into the product, which aids fusion. Again, very, very good clinical data. We believe we need clinical data in order to reinforce what we're seeing in the bench testing. And so we're initiating 150-patient study on the product. And we think with clinical data that, that should support the continued growth. And the technology -- the TETRAfuse technology is really one of the foundational technologies that we are using from a developmental perspective, and we anticipate that we'll be launching additional products within the interbody family utilizing that technology. So a long answer, but we're very optimistic on both of these products.

David Louis Turkaly - JMP Securities LLC, Research Division - MD and Senior Research Analyst

Perfect, a lot of detail. I appreciate it. Last one, obviously. A lot of talk of late in spine, a lot of consolidation, which has been a recurring theme, but a lot of discussions about navigation imaging, robotics, things along those lines. Obviously, as a player in the market, I'm just curious, from a strategic standpoint, is that something that you're interested in looking at and maybe partnering with another company or something along those lines? Just, I guess, maybe Camille's thoughts on sort of what's happening in the space and where you guys might get access to something along those lines.

Camille I. Farhat - RTI Surgical, Inc. - CEO, President & Director

Just David, this definitely is a market trend that we are seeing. I just want to come back and reiterate, we're going to definitely address our product portfolio with the organic activity and rebuilding our pipeline. That is number one. And we feel very good about the worldwide product plans that we just finished on the spine side and have initiated product development. The next step here for us on the spine side is continue to add to differentiation and then scale. And so both of these are in the cards for us as we focus on growth on the next phase. The trends in the marketplace and what customers are looking for are the solutions that would address imaging, surgical planning, robotics, that's not something that is of immediate focus for us. We clearly have thoughts about addressing that in partnerships and other things. But at this phase, we're heads down trying to focus on the medium-term growth and adding differentiation and scale to our spine business.

Operator

Your next question comes from Matt Hewitt with Craig-Hallum Capital Group.

Lucas Grant Baranowski - Craig-Hallum Capital Group LLC, Research Division - Research Analyst

This is Lucas Baranowski on for Matt Hewitt here at Craig-Hallum. And then we just had a couple of questions here. Obviously, you've done a great job finding efficiencies, and gross margin this quarter was pretty impressive. So could you provide some color on how much runway is still left for improvement?

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Jonathon M. Singer - RTI Surgical, Inc. - Chief Financial & Administrative Officer and Corporate Secretary

Yes. So as we had indicated, when we initiated the operational excellence, particularly in Alachua, we were targeting \$25 million of cost reduction. So we'll recognize \$13 million of this year, and then that will annualize with some additional initiatives at the \$25 million level. And then that approach that we took in Alachua, we're now applying to our other facilities, particularly in Marquette. And we've challenged them to a pretty aggressive goal for cost reduction, which they've begun to work on and are making tremendous progress. So I tend to look at the EBITDA margins more than the gross margins. And as we indicated in the long-term goals of the business of achieving \$500 million of revenue and 20% EBITDA margins, we're confident that through the combination of cost-reduction initiatives and investment in differentiated technologies with higher margin that we should be able to easily achieve the 20% EBITDA margins.

Lucas Grant Baranowski - Craig-Hallum Capital Group LLC, Research Division - Research Analyst

That's pretty helpful. And then one other question, there were a couple of storms and weather-related events that occurred in the southeast this quarter. How has that impacted your business?

Jonathon M. Singer - RTI Surgical, Inc. - Chief Financial & Administrative Officer and Corporate Secretary

Well, the storms that went through Florida missed us. We got a lot of rain. So grass is really green. But relative to surgical procedures, we have not seen a material decline in procedures that have impacted the business. And so I'm sure there are places in which procedures were canceled, but we have not felt that. But we have been able to track it as a specific clause for our performance.

Operator

And your next question comes from Jayson Bedford with Raymond James.

Jayson Tyler Bedford - Raymond James & Associates, Inc., Research Division - Senior Medical Supplies and Devices Analyst

Just a couple of quick modeling questions. Related to the discontinuation of map3, how big was that product just in terms of sales? And then how big ViBone was in the quarter?

Jonathon M. Singer - RTI Surgical, Inc. - Chief Financial & Administrative Officer and Corporate Secretary

Map3, overall, is just under \$20 million in 2017. It was running somewhere between \$4 million and \$4.5 million in the third quarter. ViBone, we've just begun the transition. And so the numbers, it's somewhere south of a \$1 million at this point in time.

Jayson Tyler Bedford - Raymond James & Associates, Inc., Research Division - Senior Medical Supplies and Devices Analyst

Okay. Okay. And then just similarly, on a modeling question, the impact -- sorry?

Jonathon M. Singer - RTI Surgical, Inc. - Chief Financial & Administrative Officer and Corporate Secretary

Just one other thing, I'm sorry. The important thing, and particularly from a modeling, I think we've indicated this, but I think it's important, that the gross margin and EBITDA margin of ViBone versus map3 are almost exactly the same. So even though ViBone is a distributed product, the economics of it are similar to map3 relative to the EBITDA contribution to the business.



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Jayson Tyler Bedford - *Raymond James & Associates, Inc., Research Division - Senior Medical Supplies and Devices Analyst*

Got you. Okay. Just in terms of the CT divestiture, what was the contribution of that to OEM revenue in the quarter?

Jonathon M. Singer - *RTI Surgical, Inc. - Chief Financial & Administrative Officer and Corporate Secretary*

Yes. A&E was just around, I think, it was about \$1.2 million versus -- I'm sorry, it was about \$1.5 million versus what CT had been, about \$1.7 million in the previous quarter. So really no impact per se from a revenue perspective.

Operator

(Operator Instructions) And there are no further questions in queue at this time. I will turn the call back over to Camille Farhat, President and CEO for any closing remarks.

Camille I. Farhat - *RTI Surgical, Inc. - CEO, President & Director*

Just want to thank you guys for your ongoing interest in RTI Surgical. We are focused on the execution of our plans and look forward to updating you on our progress. Have a great day everybody. Thank you.

Operator

And ladies and gentlemen, this concludes today's conference. Thank you for your participation, and have a wonderful day. You may now disconnect.

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