THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

RTIX - Q4 2018 RTI Surgical Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 28, 2019 / 2:00PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

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

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

Molly Poarch *RTI Surgical Holdings, Inc. - Director of Corporate Communications*

CONFERENCE CALL PARTICIPANTS

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

Matthew Gregory Hewitt *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

PRESENTATION

Operator

Good day ladies and gentlemen, and thank you for standing by. We welcome you to the RTI Surgical Fourth Quarter and Full Year 2018 Earnings Call. (Operator Instructions) As a reminder, this conference call may be recorded.

I would now like to turn the conference over to Molly Poarch. Please go ahead.

Molly Poarch - *RTI Surgical Holdings, Inc. - Director of Corporate Communications*

Good morning, and thank you for joining the call to discuss RTI's Fourth Quarter and Full Year 2018 Results. On the call today are Camille Farhat, our President and Chief Executive Officer; and Jonathon Singer, our Chief Financial & Administrative Officer. Camille will provide a brief strategic update and discuss the quarter and full year. Jon will then discuss the fourth quarter and full year financial results. After the 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. The statements are based on 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 uses 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 in the Investor Relations section of our website.

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

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

Good morning, everyone and thank you for joining us today. We had another solid quarter, marked by the growth in both our spine and OEM franchises. Revenue for the fourth quarter was approximately $71 million with adjusted EBITDA of $7.7 million or 11% of revenue. Full year 2018 revenue was approximately $281 million with adjusted EBITDA of $33.7 million, or 12% of revenue.

Over the course of 2018, we made substantial progress across the 3 pillars of our strategic transformation that generated solid operational and financial results.

Considering the first pillar, reducing complexity. We completed a comprehensive portfolio analysis focused on optimizing our direct channels and simplifying the structure of the business. As a result, in 2017, we sold the CT business and in 2018, we transitioned our own donor agencies, which exited RTI from tissue recovery and narrowed our focus to our core competency in tissue processing and distribution.

In 2019, we intend to continue our focus on development of our OEM and spine portfolios and simplifying our Sports channel and the continued effort to anchor our portfolio and the aspects of our business that drive growth, build scale, and simplify our structure.

To address the second pillar of our transformation, driving operational excellence, we initiated an aggressive cost reduction program across the tissue side of our business, and achieved in excess of $13 million in cost reduction and are on track to achieve our goal of $25 million by the end of 2019.

In addition, we have newly initiated programs in other parts of our global manufacturing infrastructure that will continue the momentum beyond 2019.

The cost reductions achieved in 2018, address the material acquisition of tissue as well as processing improvements, including hiring and training black belts and establishing a cadence of kaizens. Thus far, these efforts have resulted in a more competitive cost position, a shift to a continuous improvement mindset among employees and a more attractive platform for growth.

While we are pleased with the 200 basis points annual improvement in gross margin, resulting from our operational excellence initiatives, some of the changes within RTI cannot be seen solely through financial measures. The velocity of decision-making, the continuous improvement mindset and the focus on customer intimacy and service have made a cultural impact that positively contributes to an environment of predictable execution and in our ability to operate effectively and efficiently.

For the third pillar of our transformation, accelerating growth, our progress in reducing complexity and driving operational excellence have set the foundation to support RTI's future growth. As part of our strategic evaluation, we developed a long-term growth strategy for OEM and a worldwide product plan for spine. Our growth strategy in spine is to invest in differentiated products and build scale. We're executing against this strategy through external acquisition, the development of partnerships and internal R&D development. And we were successful in activating all 3 of these levers in 2018.

From an acquisition perspective in 2018, we acquired Zyga Technology for Symmetry and announced our agreement to acquire Paradigm Spine for coflex. From a partnership-development perspective, we secured ViBone as a next-generation orthobiologic through a commercial partnership with Aziyo Biologics. And when it comes to internal R&D efforts, we launched Fortilink-TS and -L with TETRAfuse technology. We anticipate each of these 4 high-growth, high-margin platforms to drive growth both domestically as well as in our international business in 2019.

Turning to the OEM business, the franchise returned to growth and is consistently performing as a predictable cash generation engine for RTI. This business continues to demonstrate the strength of our customer relationships and the importance of our existing products to our partners. Nearly half of our revenue tied to contract has been renewed to extend into 2022 to 2026. And as we progress in 2019, and based on the feedback we continue to receive regarding the level of service, quality, and innovation capabilities, we will continue to graduate remaining partners to longer-term contracts.

Now these longer-term contracts provide greater visibility with 12 months rolling forecast, greater financial predictability, with 6 months binding POs and greater opportunity for profitable growth through new product development prospects.

To this last point, our partners are increasingly tapping our innovation offering. As part of accelerating growth, we spent 2018 rebuilding the pipeline, and we have 3 to 4 promising platforms, developed internally that we believe have the potential to be future growth drivers.

We continue to hold innovation summits with partners, which will further contribute to a growing pipeline.

In addition to our successes aligned to the 3 pillars, we continued strengthening our management team, with the addition of key positions in R&D, regulatory, business development, finance, marketing, clinical and IT. We improved performance predictability through the implementation of standardized management tools and processes. We also delivered on quarterly performance expectations, while absorbing the impact of our decision to discontinue distribution of our map3 implant.

We selected ViBone based on its clinical profile and similarities to the key qualities we found most attractive in map3. It is relatively early in the product life cycle, and we are investing in building the body of clinical evidence, just as we did to support the science behind map3.

We are already seeing good momentum with ViBone and will continue to pursue surgeon evaluations and improve access within hospitals and health systems.

And while the initial feedback has been positive, we anticipate 1 to 2 quarters of challenging comparisons as we progress through this product transition and the adoption of ViBone ramps-up at a measured pace.

Now to provide an update on Paradigm spine, we are looking forward to the shareholder vote on the transaction on March 7, 2019. We are confident Paradigm is the right deal at the right time for RTI. Paradigm's product -- primary product, coflex, is a differentiated, high-margin, FDA PMA approved implant. It is supported by more than 12 years of clinical data with expanding coverage from private payers.

Further, adding coflex to our portfolio, solidifies RTI's position in the lumbar spinal stenosis space, a large established market and strengthens our position as a leading global provider of spine care.

Paradigm finished 2018 with good momentum, including recent insurance coverage decisions from AmeriHealth and SelectHealth. We anticipate a smooth integration and look forward to welcoming many Paradigm spine team members to expand our U.S. and international sales teams. When combined with the scale and infrastructure of RTI, we are confident we will return coflex to growth in 2019 and beyond. Overall, in 2018, in addition to accelerating our acquisition activity, we focused heavily on rebuilding our R&D pipeline in spine and OEM to accelerate our long-term sustainable growth.

In parallel, we focused our commercial efforts on leveraging our 4 platforms in spine. And further, we continue to be successful in reducing complexity and driving operational excellence. Our team is executing effectively, our strategic initiatives are now ingrained in our corporate culture, and we are producing improved operational and financial performance, and we have built a solid foundation for organic and inorganic growth in 2019 and beyond. And with that, I will hand over to Jon to outline our financial performance.

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

Thank you, Camille. Jumping right in at the top. RTI's worldwide revenue for the fourth quarter of 2018 were $71.2 million compared with $70.8 million during the same period for the prior year. Fourth quarter revenue were driven by the 5.7% growth in the spine franchise with strong demand from Fortilink and Symmetry and continued solid contribution from OEM, partially offset by declines in Sports and international.

Gross profit for the fourth quarter of 2018 was $38.7 million and the increase of $2.5 million or 6.8% compared to $36.3 million for the comparable prior year period. Gross margins -- gross profit margins were 54.4% of revenues compared with 51.2% of revenue in the fourth quarter of 2017. The

300 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.

Marketing, general, and administrative expenses were $31.9 million for the fourth quarter of 2018, an increase of $3.6 million or 12.9% compared to $28.3 million in 2017. The increase is predominantly driven by commission on the growth in spine, the addition of Zyga acquired at the start of 2018 and the increased legal cost related to patent litigation. Research and development expense were $4.1 million in the fourth quarter of 2018 compared to $3.1 million in 2017.

The increase in R&D is driven by the acceleration of our organic growth investments. During the fourth quarter of 2018, we incurred nonrecurring pretax charges to support the ongoing strategic transformation of the business. We incurred $2.2 million of acquisition and integration cost to support the acquisition of Paradigm. In addition, we incurred about $0.6 million of severance and restructuring charge to complete the rationalization of the international infrastructure and transition distribution to a third-party logistics partner.

During the fourth quarter of 2017, the company incurred $8.7 million of nonrecurring charges. Adjusted earnings before interest, taxes, depreciation and amortization, also known as adjusted EBITDA, for the fourth quarter of 2018 was $7.7 million or 11% of revenues compared with $9.4 million or 13% of revenue for the fourth quarter of 2017.

The decline in adjusted EBITDA is due to increased patent litigation cost and operating expenses focused on accelerating growth, driven primarily by incremental operating cost from the acquisition of Zyga Technologies. These increased costs were partially offset by gross margin expansion associated with the efforts to reduce complexity and increase operational excellence initiated during 2017.

Net income applicable to common shares was $2.1 million or $0.03 per fully diluted common share in the fourth quarter of 2018 compared to a net loss applicable to common shares of $8.6 million or $0.14 per fully diluted common share in the fourth quarter of 2017.

As outlined in the reconciliation tables presented in our earnings release, excluding the impact of the various nonrecurring charges, adjusted income applicable to common shares was $3 million or $0.04 per fully diluted common share in the fourth quarter of 2018.

Transitioning to the full year, worldwide revenues were to $280.9 million for the full year 2018 compared to revenues of $279.6 million for the full year 2017. Excluding the $8.2 million reduction for the sales, substantially all the assets in the cardiovascular closure business completed in August of 2017, total revenues increased $9.5 million, or 3.5% driven by growth in both spine and the OEM franchises.

Gross profit for the full year of 2018 was $140.1 million compared with $142.5 million for the comparable prior year period. 2018 gross profit was impacted negatively by an inventory write-off of $7.6 million, primarily related to suspension of distribution of our map3 implant and the purchase accounting step-up adjustments to Zyga inventory of $0.6 million charged to cost the processing distribution as the inventory was sold. When adjusted for the impact of these nonrecurring charges, gross profit as a percentage of revenue, were 52.8% for the year ended December 31, 2018, compared with 51% for the comparable 2017 period. The approximate 200 basis point improvement in margins from last year is partially related to mix in the spine portfolio and predominantly relates to the operational excellence initiatives we have taken in our tissue processing operations, and which were on track to reduce the cost by approximately $25 million by the end of this year compared to year ending December 31, 2016.

Adjusted earnings before interest, taxes, depreciation and amortization for 2018 was $33.7 million compared with $32.3 million in 2017.

Net loss applicable to common shares was $3.4 million or $0.05 per fully diluted common share 2018 compared to net income applicable to common shares of $2.5 million or $0.04 per fully diluted common share in 2017.

Again, 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 $7.6 million or $0.12 per fully diluted common share for the year ended in December 31, 2018.

Briefly looking at liquidity, our cash position, at the end of 2018 was $10.9 million, and working capital totaled $119.7 million. We had approximately $50 million outstanding on our ABL at the end of the year.

Turning to guidance. Based on our recent financial results in the current business outlook, we developed the following financial guidance for 2019.

We expect full year revenue of approximately $325 million to $335 million, representing approximately 15% to 19% growth over the prior year. We expect full year adjusted EBITDA to be in the range of approximately $36 million to $40 million, representing approximately 7% to 19% growth over the prior year.

With regard to our capital structure, based on the anticipated growth of the spine portfolio, predictable cash generation from the OEM franchise, and further efforts to reduce complexity, it is our goal to reduce debt to EBITDA to less than 4 by the end of 2019.

I would note the following assumptions that underpin our guidance: relatively stable economic and market conditions and regulatory environment; ongoing positive impact from efforts to reduce complexity and implement operational excellence; the successful closing of the acquisition of Paradigm Spine in early March, 2019; and a positive EBITDA contribution; sustained favorable reimbursement from private payers; and the successful ongoing transition from map3 to ViBone.

As we look at the start of the year, we expect the legacy RTI business will be down approximately $4 million versus the first quarter of 2018, primarily due to the timing of OEM orders. We anticipate Paradigm will contribute approximately $2 million of revenue, assume any weakened consolidating results mid-March. Operator, I would like to open the line to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Dave Turkaly with JMP Securities.

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

I think you mentioned a couple of private payer reimbursement wins for coflex and the fact that they have 12 years of data. I was just wondering if you could give us some color around either lives covered or, kind of, percent of private payer coverage you think you're at now. And what you think that'll look like in 2019? Because I think you said back to growth at that point.

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

David, it's Camille. What I will say around the coverage situation is we have about $50 million covered lives through Medicare on a national level. And then the other payers continue to garner momentum, and we add about $2 million to $3 million on top of that for now. That's an effort -- as we all know that takes quite a bit of effort, and we continue to work through it. It's -- the clinical data is pretty there -- pretty much there. With 160,000 implants, this is not a safety question with 5-year data that is showing sustainability of positive outcome and saving the hospital system money from having to basically go overlay diffusion on some of these patients. This is the strategy that underpins the Paradigm acquisition and the data that supports it along with the support from the 4 societies. So I would say that if you compare that to other novel therapies in the spine space and their adoption curve, you are exactly where you need to get to. The other element is, I think, that there is a -- we will continue to see, I think, continued growth that will underpin that therapy in motion preservation and not overtreating certain patients. That is kind of independent from the insurance coverage as well.

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

Got it. I think you said that you have some of their reps coming on board.

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

Yes.

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

Certainly, spine's going to be -- yes. Your driver, looking ahead, I was wondering if you might comment on sort of the size of the scale of what you guys would look like in spine post to closing of that? I think given you have all these new products, I don't know if you'd like to take a shot at what the growth rate for that business could be for you looking up? But certainly it seems like it should accelerate and maybe stay at an accelerated rate for a number of years?

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

I'll set the framework, and then we can talk about the growth rate.

We're excited about this and this is a -- we find ourselves in a very unique situation. Usually, most companies in spine are either trying to establish a clinical sales force to try to take a novel therapy to standard of care or they have an established distribution infrastructure in established therapies to do that. And we're trying to do both as we serve the same surgeons and ultimately, the right patient.

So the majority of the Paradigm team comes over. There are some nuances in realignment, but basically, you're going to have a continuation of what we have seen, where you have novel therapies, you need clinical data and you've got to push that to standard of care. That requires more detailing usually than distributors are either willing to commit to or willing to invest the time in. And so we find ourselves needing to support them just like we did with the Symmetry this year, and just as we're seeing in Paradigm having done in the second part of '18 and continues to do that now. So there is an element, where we have to come and be equipped with the data, be able to have the conversation, be able to do the training, and then add the comfort level of the surgeon and the distributor, you turn that over, and then you move on to the next account. So that's really the approach that we are taking and then in anticipation of the product, yes, we're excited. The platforms, the 4 platforms are high growth, high margin, so whether you look at ViBone, whether you look at Symmetry, coflex, that is what is changing, and that's what we're built in 2018 to take us to the next level. In terms of growth numbers, I'll have Jon comment a little bit on that.

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

Yes. And I think, Dave, your question is a good one because when you look globally and you combine our domestics business with our international franchise with the close of Paradigm, which will be predominantly spine, you've got a combined spine business globally that's approaching $150 million in revenue. And we believe that it should grow at least 2x the market growth rate. And that's the minimum that we're pushing towards relative to the long-term planning. And as Camille indicated, between Symmetry, ViBone, the coflex product and the market acceptance of Fortilink, plus the investments that we're making in organic new product development, we're comfortable that we should achieve those long-term growth rates.

Operator

And our next question comes from the line of Matt Hewitt with Craig-Hallum Capital Group.

Matthew Gregory Hewitt - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

A couple for me. First, just one point of clarification. I think, Jon, did you mention $2 million from Paradigm? And it sounds like that was kind of a first half or beginning of the year? Is that correct?

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

[It's a prior year], it's approximately $2 million that we'll get. We've got the shareholder vote on the 7th. So we'll essentially pick up the back half of March from a consolidation perspective, and it's somewhere around -- you're rounding for 3 weeks of sales, but it's approximately $2 million of contribution.

Matthew Gregory Hewitt - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Okay, but then -- and then you would get to a more normalized, if you want to call it that, run rate for the remaining 3 quarters of the year?

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

Right. Instead of 2 to 3 weeks, we'd have 4 months in quarters. Yes.

Matthew Gregory Hewitt - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Got it. Okay. And then, we're -- obviously, this has been delayed, the closing. Everyone's a little frustrated by that, but given this delay, what kind of work have you been able to complete, while you were waiting for the government to reopen and kind of check their boxes? Have you been able to work with the Paradigm teams? Or has that kind of been put on hold as well?

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

No, not at all. I mean we've -- there's obviously, rules around what you're able to do and talk about, but within the context of the SEC rules, we've been very, very actively engaged with the Paradigm team. I mean this has really been a partnership with the Paradigm leadership and ownership from the outset. And kind of given that they're going to be significant shareholders going forward, everybody's very aligned on driving towards a successful integration and closing the deal with momentum. And so, we've had a comprehensive integration team on both sides working on a consistent basis. So when we close this transaction, we'll hit the ground running. I mean, some of it's simple, and some of it's complicated. It's -- we got everybody signed up for benefits and on payroll, we got everybody with RTI e-mail addresses, all the things that kind of get in the way of people being effective in their roles. Everybody's clear about what their role's going to be going forward, and we've got a solid design of the commercial infrastructure, both domestically and internationally going forward.

And so, we've done a ton of work and have had tremendous cooperation and collaboration, and so we feel very good about where we're positioned at the outset of the close.

Matthew Gregory Hewitt - *Craig-Hallum Capital Group LLC, Research Division - Senior Research Analyst*

Great. And then, moving down a little bit -- gross margins. How will coflex and Paradigm impact gross margins, maybe first half of the year versus second half of the year? And then maybe even if you think a little bit longer term, without getting too specific numbers, but as you transition to more of these differentiated spine products in the platform, is it your expectations that gross margins will continue to lift for the medium-term, 3 to 5 years?

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

Yes, obviously, when you look at Symmetry, coflex, Fortilink, these are all products that have gross margins that are well in excess of 70%, 80%. And so as they become a larger portion of the overall portfolio, they're obviously, going to contribute positively to the consolidated gross margin. So -- and, as we indicated in the core business, we're on track to take another, $12-plus million of cost out in the base. So we finished the year just in the core business, we anticipate continued progression in gross margin, and we should be well in the mid-50s prior to the close of Paradigm. And then, with the contribution from Paradigm on a consolidated basis, we should, in the back half of the year, be approaching 60% or above.

Operator

And I show no further questions at this time. I would like to turn the call back over to Camille Farhat, President and CEO, for closing remarks.

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

Thank you, George, appreciate that. I appreciate everybody joining us and making time this morning. We are confident that our strategic transformation continues to build momentum, and we are creating an organization with significant long-term value. We are focused on the execution of our plans, and we look forward to updating you on our ongoing progress. Again, thanks for joining and have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.
