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RTIX.OQ - Q2 2019 RTI Surgical Holdings Inc Earnings Call

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AUGUST 01, 2019 / 1:00PM, RTIX.OQ - Q2 2019 RTI Surgical Holdings Inc Earnings Call

## 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

**Craig William Bijou** *Cantor Fitzgerald & Co., Research Division - Research Analyst*

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

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

**Patrick T. Ford** *Glen Capital Partners LLC - VP*

## PRESENTATION

### Operator

Good morning, ladies and gentlemen, and welcome to the RTI Surgical Holdings Conference Call. (Operator Instructions) I would now like to turn the call over to Ms. Molly Poarch. Please go ahead.

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

Good morning, and thank you for joining the call to discuss RTI's Second Quarter 2019 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. Jon will then discuss the second 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 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.



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

Thanks, Molly, and good morning, everyone. For the second quarter, we delivered record revenue of approximately \$82.3 million with adjusted EBITDA of \$9.9 million or 12% of revenue. These results are attributable to strong performance from our Global Spine and OEM franchises and further amplified by the addition of coflex to our Novel Therapies spine portfolio.

Beginning with our Global Spine business, we are pleased with the double-digit top line growth of our legacy spine hardware business. We are experiencing strong continued performance of the Fortilink family of products. Notably in the United States, we reached the milestone of 5,000 implants of Fortilink C, TS and L interbody fusion systems with TETRAfuse 3D technology. This product family continues to be recognized for its innovation, including recently receiving its second technology award, the 2019 MedTech Breakthrough Award.

In the second half of 2019, we anticipate continued growth of our spine hardware portfolio, as we expect our reinvigorated R&D efforts to begin to bear fruit with the commercial launch of our CervAlign Anterior Cervical Plate System and continued expansion of the Fortilink product family. In considering the Novel Therapies portfolio within our Spine franchise, the integration of coflex continues to progress forward. We are investing significant time and resources to develop a unique operating model to drive the performance of our differentiated portfolio over the long term. We believe this is the right approach for the business. However, we are making progress at a slightly slower cadence than anticipated.

We estimate, we are approximately 6 months behind our initial plans on the onboarding and training of people in new roles and the transition of our selling focus to our new commercial operating systems. On the positive front, we are seeing significant commercial opportunities for coflex in key states where we have strong private and public payer coverage, and we have a strong base of surgeon experience with coflex. Further, we have improved our focus in identifying patients for whom coflex is an important motion-preserving alternative to fusion.

I am also pleased to share 2 new managed care companies that issued update -- I'm sorry, have issued updated clinical policies covering the coflex device. One in Florida, serving 330,000 lives, and one in Arkansas, covering 89,000 lives. These policies went into effect on June 1, 2019, and bring our total covered lives to well over 50 million. We intend to focus the second half of 2019 on continuing to build the commercial operating system and to ensure the right mix of team members are in place to culturally and operationally drive the overall performance for our Novel Therapies portfolio. This new approach is focused on creating a consistent and reproducible process for sales execution, focused on better targeting through patient education and surgeon training, enhanced patient referral through demand generation activities and long-term increases in reimbursement through clinical data and product positioning.

Overall, we remain excited by the market opportunities for coflex and look forward to accelerating progress in integrating coflex and building a unique commercial model that will support future growth of the novel therapies portfolio.

Turning to the rest of the business. The OEM franchise delivered a record quarter fueled by our emphasis on customer intimacy and focused innovation. Our customers are increasingly seeking our unique and innovative OEM solution, which includes product design and development, regulatory filing execution and product fulfillment across tissue, biologics and hardware. Increasingly, medical device companies are seeking our domain expertise in the creation of distribution-ready products to address their portfolio specific needs as well as the demands of surgeons and patients.

Our OEM team is 18 months into their strategic transformation, and we're seeing the benefit in their enhanced predictable execution and contribution to our growth. In total, we are pleased to see continued success from our efforts to reduce complexity, drive operational excellence and accelerate the growth of RTI.

We continue to evaluate opportunities to simplify our channel strategy for our tissue-based products in favor of stronger direct customer channels. Our operational excellence initiatives remain on track, and we expect to deliver the balance of anticipated cost savings in 2019. The predictable revenue performance from OEM and Sports, combined with our continued efforts towards operational excellence, provide reliable EBITDA contribution and support our efforts to accelerate the growth of our Global Spine franchise.



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In addition, following the acquisition of Paradigm Spine, our R&D efforts are further bolstered by the creation of a new design center in Germany that leverages Paradigm Spine's talent and capabilities as well as a restructuring of our global R&D organization focused around key platforms, aligned with our product categories to drive future new product development and growth.

Overall, we are pleased with both our strong performance in the first half of 2019 and the outlook for the rest of the year.

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 revenues for the second quarter of 2019 were \$82.3 million and \$11.6 million or 16.4% increase compared with \$70.7 million during the same period for the prior year. Driving 2019 revenue is growth across most franchises led by [\$10.1 million] (corrected by company after the call) global contribution from coflex and \$1.4 million growth in OEM, contributing to a record quarter for that franchise. Gross profit for the second quarter of 2019 was \$44.7 million or 54.4% of revenue, a 49% increase compared to \$30 million or 42.5% of revenue in the second quarter of 2018.

Gross profit for the second quarter of 2019 included a \$2.9 million charge for the purchase accounting step-up of coflex inventory. Gross profit for the second quarter of 2018 was impacted by an inventory charge of \$6.8 million from the write-off of inventory related to decreased distribution of our map3 implant and the purchase accounting step-up on Zyga inventory.

Gross profit adjusted for the impact of nonrecurring charges was 57.9% of revenue for the second quarter of 2019 compared to 52.1% of revenue for the prior year quarter. The nearly 600 basis points improvement in margin from last year is evidence of solid achievement of our efforts to drive operational excellence in the accretive margin impact from the addition of coflex. Marketing, general and administrative expenses were \$39 million for the second quarter of 2019, an increase of \$9.7 million or 33.2% compared to \$29.3 million in 2018. The increase is predominantly driven by the addition of Paradigm and the investment in our sales and marketing infrastructure to create the commercial operating system to drive the growth of our Novel Therapies portfolio.

Research and development expenses were \$3.9 million in the second quarter of 2019 compared to \$3.3 million in 2018. The increase in R&D is driven by acceleration of organic growth investment in our pipeline. During the second quarter of 2019, we incurred \$2 million of nonrecurring acquisition and integration costs to support the acquisition of Paradigm Spine and a \$1.6 million gain on acquisition contingency due to an adjustment of our estimates of the application for future milestone payments. Adjusted earnings before interest, taxes, depreciation and amortization, also known as adjusted EBITDA for the second quarter of 2019 was \$9.9 million or 12% of revenues compared with \$9.1 million or 13% of revenues for the second quarter of 2018. The increase in adjusted EBITDA is driven by the gross margin expansion, partially offset by the investment in sales and marketing outlined earlier.

Net income applicable to common share was \$700,000 or \$0.01 per fully diluted common share in the second quarter of 2019 compared to a net loss applicable to common shares of \$6.4 million or \$0.10 per fully diluted common share in the second quarter of 2018. As outlined in the reconciliation tables presented in our earnings release, excluding the impact of the various nonrecurring charges, adjusted net income was the same as GAAP net income.

Turning to guidance. Based on our current business outlook, we are reiterating financial guidance for 2019. We expect full year revenues up \$325 million to \$335 million, representing approximately 15% to 19% growth over the prior period. We expect full year adjusted EBITDA to be in the range of \$36 million to \$40 million, representing 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 for the OEM franchise and further efforts to reduce complexity, it is currently our goal to reduce debt-to-EBITDA to less than 4x 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 impacts from efforts to reduce complexity and implement operational excellence; the continuing successful integration of Paradigm Spine and a positive EBITDA contribution from Paradigm Spine acquisition, which closed in March of 2019; sustainable favorable



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reimbursement from private payers; and the successful ongoing transition from map3 to ViBone. Our guidance is intended to be the full year, however, given that everyone develops quarterly models, I'll share some thoughts on the performance in the third quarter 2019.

We currently expect revenue growth will be in the range of 15% to 16% over prior year, predominantly driven by global contribution from the Paradigm acquisition. This is slightly lower than previously expected due to the delay of Novel Therapies progression outlined by Camille earlier in the call is slightly lower than Q2 results due to timing of OEM customer orders. Operator, I'd like to open the line for questions.

### QUESTIONS AND ANSWERS

#### Operator

(Operator Instructions) And our first question comes from the line of Matt Hewitt with Craig-Hallum Capital.

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

This is Lucas Baranowski on for Matt Hewitt here at Craig-Hallum. A few different questions asked today. But I guess, I'll just start with OEM. It looks like you had a pretty good quarter on that front. Would you say that may be attributable with some of the changes that were made to the sales force on that side of the business around a year ago? Or has there maybe been some sort of a shift in just general customer trends?

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

Well, I think there's probably 2 to 3 drivers of that, Lucas. It's -- first off, as we indicated in the script, we began -- obviously, the strategic transformation of RTI 18 to 24 months ago, and Olivier, who's been in place running the OEM franchise has been in his seat for over 18 months. And so the stability of the leadership team and the focus on customer intimacy and operational excellence is resonating with our customers. And so we're beginning to have a more regular cadence of interaction with them. And they're working with us collaboratively to identify opportunities to expand the relationship. I would say, today we're seeing very, very strong progression on the tissue side of the business, but we're also seeing opportunities across the entire portfolio.

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

That's helpful. And then, I guess, turning to coflex. You talked a little bit about reimbursement. It sounds like you had a couple of wins there in Florida and Arkansas. How should we be thinking about the potential for more reimbursement wins in the coming quarters, like maybe the cadence of potential wins?

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

Yes. I mean, look, as you know, these are not incredibly predictable. What I would continue to reiterate is the opportunity for coflex and the growth that we anticipate in the short-to-medium term is going to come from our commercial operating system, which is focused on better execution and more predictable recipe as well as surgeon engagement. We think that when you have over 50 million covered lives for the growth patterns that we have in the areas where we have coverage, we feel very good about the growth trajectory. And then, of course, we continue to work with the clinical evidence under private payers to continue to get to that ever-increasing number of covered lives, though that is not that predictable. So I just want to reiterate that. We'll continue to update everybody as we get these successes, but our focus is more on our own building and stating our commercial operating system for the Novel Therapies, and we believe that, that would be enough between that and surgeon engagement to get the growth we were articulating.

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

Okay, I understand. And I guess, one more question here. Just on gross margin. Earlier in the year, there were a couple of initiatives that you had going on to improve that. You had talked about \$25 million in cost reductions, I believe, it was for of the tissue business. You talked about maybe making some changes in the Sports business. So is there any kind of an update you can provide on some of those gross margin initiatives?

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

Well, I would say, based upon the 600 basis points expansion that we experienced during the quarter that they're on track. So we had targeted \$25 million in cost reduction out of our tissue-manufacturing infrastructure in Alachua over the 2-year period, and we're on track to recognize that. The team in Marquette is doing a phenomenal job of driving operational excellence and increasing volumes out of that facility without significant increase in variable cost. And so we're comfortable with the progression that we're seeing in the margin and anticipate that we'll continue to see sequential expansion quarter-over-quarter, maybe not at the same rates that we've seen over the past couple of quarters, but we're excited about the opportunity and the success that the team has had in driving those initiatives.

**Operator**

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

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

Jumping back and forth a bit here, but I think you mentioned on the OEM side that you're seeing opportunities across the portfolio. You might have even said metal and biologics. I'm curious is -- are these customers, the same guys that you're dealing with on the tissue side? Or are you actually partnering up with new organizations now, maybe across those other areas?

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

Yes. So in general, the opportunities are with existing customers. And within our customer base, we actually have a broad cross-section, even within our top customers, we've -- we're delivering both tissue, biologics and hardware. So a couple of the opportunities are with newer, large OEM providers. But in general, David, it's expansion of relationships through our customer intimacy initiatives into existing customers.

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

Got it. And then on the Paradigm side. I was wondering, would you be willing to break out the U.S. -- OUS contribution? And I know Camille was talking about the new sales channel for the Novel Therapies. Just any update here? And I heard the comments on the onboarding may be taking a little longer, but comments on maybe the size of that initiative, headcount-wise? Or how many people you have, where you think you're going across that sort of -- that new area? Are you going to manage it separately? Or are there any kind of stats you can give us to just give us an idea of the size that it is today?

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

Yes. So I'll answer at a high level from a financial perspective, and then Camille can get into a little bit of the detail. So in the second quarter, approximately 75% of the global coflex revenue was domestic. So 75%, 25%. It's not perfect, but it's directional. And from a -- we won't go into the detail on the numbers of people, but the Novel Therapy infrastructure is a separate and distinct sales and marketing infrastructure. And in the quarter, most of the incremental spend in SG&A was geared towards supporting that from both the domestic and international perspective. So I think it was -- it's about \$9.6 million from a spend perspective. And then Camille can talk a little bit more from an activity perspective.



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

So we have been talking consistently about our strategy of differentiation and scale. And around the differentiation, we talked about taking Novel Therapies that our surgeons have graduated and most of them haven't seen them getting done with their residency or fellowship. And we're going to take these to standard of care. So we're spending a lot of time in energy on the different parts of it, which is the clinical selling aspect, the support and training and case coverage, the activation of the sites and the support of the practice clinically as well as the reimbursement support that goes around both of these current differentiated therapies. So it is probably the best analogy would be maybe comparable to what SI-BONE is creating. So internally, we have two sales forces, one for established therapies that relies a lot more on distributor and service, and another one, more like a missionary selling where you got to engage in the dialogue about what is the standard of care today, and how is that evolving, finding the right patient for our therapies on label and then getting the surgeon through early cases before we turn them back over to their distributor for continued case coverage. That's the uniqueness of what we're creating in both of these sales forces. They are managed separately, but they do interlink at the customer and the distributor level.

**Operator**

Your next question comes from the line of Craig Bijou with Cantor Fitzgerald.

**Craig William Bijou** - Cantor Fitzgerald & Co., Research Division - Research Analyst

I want to start on the commercial sales force. Another question there. And just, I guess, I wanted to understand a little bit more about what you guys have seen? That's kind of force that to be pushed out 6 months. I know you closed -- in early March, you closed the Paradigm deal. So I guess, in that interim or in that period, maybe what you have seen or what's caused you to kind of push out that the Novel Therapy expectation or time line 6 months? And then also, you obviously reaffirmed guidance. So -- and I understand that the cadence may be a little bit different between the third quarter and fourth quarter, but pushing out this -- the sales force, the structure doesn't have -- doesn't seem to have impacted you guys from a financial perspective. So just wanted to -- maybe a little bit more color on that as well.

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

Yes, I appreciate the question, Craig. And I'll frame it, we'll talk more and then Jon can talk about the phasing for the rest of the year. I would say that we had 3 elements in the delay. One, as you know with the SEC delay in closing as the SEC was shut down. We got delayed a couple of months on the closing. With the uncertainty in the sales force, we ended up starting from a lower base than we thought. Two, our energy and focus during the integration has been around the 4 basic elements of that structure that I just articulated in the previous question. And so we have that in place. We closed the first quarter, we got into the integration in April, the structure was outlined and as we started looking at people, who stays and who needs rotation, along with new leadership in our spine business that delayed us. And candidly, I think I would say, almost half of the sales force that stayed ended up in newer roles. And so there is a bit of a phased transition that took longer than we really thought. That's around the 3 parts of that delay. The part that continues to be encouraging is existing coflex users are reengaged, and we're seeing a lot more enthusiasm around their focus on the right patients for the therapy. And that's encouraging for us as we move forward, and as we're onboarding the right profile and training them, we feel that, that will accelerate the momentum, but just from a delayed start. So with that, I'll turn it to Jon for more color on the phasing.

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

Yes. And I -- we had a pretty broad revenue range on guidance. And so I think the delay -- if everything has hit and all, I guess, as Novel Therapy gets up and running, it's going to be a 12-cylinder engine. If everything was hitting on all cylinders, we would have been at the upper end of the guidance range. We'll likely finish closer to the lower end of the guidance range in line with current expectations. And it's really a combination of -- we've got a broad portfolio. And so Novel Therapies is an area of focus for growth. But when you look across the established therapy and the investments we've made in organic development, we're seeing good traction there. The restructuring of the international sales organization with



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an increased focus on spine. We're seeing good opportunity there. And then, as we talked earlier, the progression of OEM and some expanded opportunities, in particular that offset some of the timing delays from the progression of Novel Therapies. So it's just -- we've got a lot of levers that we're managing within the business in order to deliver on our commitments and the management processes and the focus on increased and predictable execution for RTI as a whole is functioning effectively.

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**Craig William Bijou** - *Cantor Fitzgerald & Co., Research Division - Research Analyst*

Got it, that's helpful, guys. So next, I just wanted to talk about the legacy Spine business. So you guys had double-digit growth this quarter. I think that was a little bit of a step-up from 9% in Q1. So wanted to see -- can that growth rate accelerate in the second half of 2020? Or how should we think about the sustainability of the double-digit growth rate for, call it, the next 18 months or so?

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

Yes, I think it's -- our goal that we've indicated for the growth of the legacy or established therapies is twice the market growth rate and so over the long run. So I think high single-digit growth is sustainable. Double digit, we are benefiting a little bit from just the timing in comparables, Fortilink was launched, I think in early -- in either late Q1 or early Q2 last year, and that was only with cervical. So we've launched a more comprehensive -- so we're getting the benefit of the full portfolio. We're getting the benefit of ViBone being kind of fully launched within the organization. We've got CervAlign, which is -- went through beta during the quarter, and we'll get full launch in the back half of the year. And then we've got a pretty stated -- steady cadence of new products that we anticipate, both from a hardware and biologics perspective. So kind of a long answer to your question. I think the short answer is, we're comfortable with our guidance -- our long-term guidance around twice the market growth rate. I think 18 months of double-digit would be a stretch, but not out of the room of possibility, but I think we're more focused on kind of what we talked about earlier.

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**Craig William Bijou** - *Cantor Fitzgerald & Co., Research Division - Research Analyst*

Great. And lastly, just wanted to touch on the map3 headwind and the ViBone ramp? Any color there? And kind of, is that in line with what your expectations had been? Or -- I mean, any other color on how each of those are progressing?

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

Yes. So there's about 1 million, 1.2 million of headwind from the conversion of ViBone to map3 in the quarter. That impact will diminish in the back half of the year, and we're seeing good progression across -- actually, across the -- what I would call the biologic portfolio with ViBone being a piece of it. And so I would say ViBone is generally performing in line with our expectations. There's a couple of configurations, particularly the strip configuration, which was kind of really well liked by many surgeons that we had with map3 that we're working with our partner on ViBone to develop. I think when that gets launched along with some of the data that we're accumulating with the clinical work that we're doing, we'll see continued acceleration. So I think in summary, we're generally in line with what we expected and it continues to be an important part of the overall products that we're delivering with the established therapeutic portfolio.

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**Operator**

(Operator Instructions) We do have a question from the line of Patrick Ford with Glen Capital Markets.

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**Patrick T. Ford** - *Glen Capital Partners LLC - VP*

This is Pat here. Just one quick one for you. Could you characterize, sort of the revenue performance of coflex in the first half of the year versus the first half of 2018?



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

Yes. I think it is sequentially down about 7% since -- versus the first half of last year.

**Operator**

(Operator Instructions) There are no further questions in queue. I will now turn the call over -- back over to the presenters.

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

Thank you, everybody, for making the time for joining us and your ongoing interest in RTI Surgical Holdings. 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 look forward to updating you on our ongoing progress. Have a great day, everybody. Thank you.

**Operator**

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation, and have a wonderful day. You may all disconnect.

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