Agilent Technologies

Agilent Technologies Second Quarter Fiscal 2019 Conference Call Prepared Remarks

ANKUR DHINGRA

Thank you, and welcome everyone to Agilent's Second Quarter Conference Call for Fiscal Year 2019. With me are Mike McMullen, Agilent's president and CEO, and Bob McMahon, Agilent's senior vice president and CFO.

Joining in the Q&A after Bob's comments will be Jacob Thaysen, president of Agilent's Life Science and Applied Markets Group; Sam Raha, president of Agilent's Diagnostics and Genomics Group; and Mark Doak, president of the Agilent CrossLab Group.

You can find the press release, investor presentation and information to supplement today's discussion on our website at investor.agilent.com.

Today's comments by Mike and Bob will refer to non-GAAP financial measures. You will find the most directly comparable GAAP financial metrics and reconciliations on our website.

Unless otherwise noted, all references to increases or decreases in financial metrics are year over year. References to revenue growth are on a core basis. Core revenue growth excludes the impact of currency, and the acquisitions and divestitures completed within the past 12 months. Guidance is based on exchange rates as of April 30th.

We will also make forward-looking statements about the financial performance of the company. These statements are subject to risks and uncertainties and are only valid as of today. The company assumes no obligation to update them. Please look at the company's recent SEC filings for a more complete picture of our risks and other factors.

And now, I'd like to turn the call over to Mike.

MIKE MCMULLEN

Thanks, Ankur – and thanks for joining our call today.

Our Q2 results are mixed. On one hand, we continue to deliver strong growth in two of our three businesses. On the other hand, our LSAG business is experiencing unexpectedly soft market conditions. Despite revenue below our expectations, the Agilent team delivered solid earnings with EPS of $0.71 -- at the midpoint of our guidance. This represents 9 percent EPS growth over last year. We also delivered our 17th consecutive quarter of adjusted operating margin expansion.

For the quarter, total revenues were $1.24 billion, representing 4 percent core growth. Let me break that down.

Performance was led by our Agilent CrossLabs Group with core growth of 9 percent. Our Diagnostics and Genomics group delivered 6 percent core growth, while our LSAG business declined 1 percent.

There were two key market factors, observed in the latter part of the quarter that contributed to the LSAG revenue shortfall. First, we're experiencing a slowing of instrument orders in China. The second factor is tied to a more general slowdown in orders from big Pharma. I'd point out that this slowdown became apparent to us at the beginning of April.

Let me explain this in a little more detail.

In China, our overall business grew 3 percent, driven by strong double-digit growth in ACG. However, our LSAG business declined by 1 percent during the quarter. There are two major factors impacting our China LSAG business.

First, the recovery in the Food market has not yet materialized. Government labs have not yet resumed purchasing at the levels we had previously seen.

Second, the Chinese government's "4+7" initiative to lower generic drug prices, is having a greater than expected impact on small molecule pharma.

Consequently, we're lowering our revenue expectations for China this year. China, does however, remain an important long-term growth market for us.

The other factor affecting LSAG growth is moderating global demand in small molecule pharma. We've seen several large accounts delaying replacement purchases. In contrast to small molecule pharma, we continue to see strong global Biopharma demand.

While overall growth declined 1 percent, there are positive signs in other LSAG end-markets. Demand remains strong in the Environmental & Forensics and Biopharma markets, with solid results in Chemical & Energy.

You'll recall we strengthened our leadership in Gas Chromatography with the recent launch of the new 8860 and 8890 GC's. Since the launch, we've been very pleased with the stronger than expected customer demand we've seen.

We also have some other very exciting new products. In April, we introduced the new Agilent 6546 LC/MS Q-TOF system. This system is tailored to environmental, metabolomics research and food testing laboratories, providing the ability to acquire high-resolution data across an unprecedented dynamic range. Customers can see more compounds and analyze them more quickly with this new offering.

In addition, during the quarter we also introduced a unified, purpose-built portfolio of cell-analysis products targeting cancer immunotherapy with the addition of ACEA Biosciences. This offering enables research in this fast-growing segment. Our cell analysis business continues to deliver double digit growth.

While we're facing soft market demand in our LSAG business, we remain confident in the strength of our portfolio – and believe we're well-positioned to continue winning in the market.

Now, I'd like to share more detail about the other two businesses.

The Agilent CrossLab Group continues to deliver excellent results - growing 9 percent on a core basis. Demand is broad-based across all regions. This reflects the market leading value of our portfolio and differentiated customer experience.

In China, the ACG business grew in the mid-teens. The team continues to execute on its strategy of leveraging Agilent's large instrument installed base. We also continue to expand our services footprint in emerging cities and tailor our consumables portfolio to the local market.

The Diagnostics and Genomics Group delivered a solid quarter with 6 percent core revenue growth. Regional demand is led by strength in the Americas.

Our Pathology related businesses grew high-single digits. Previously announced large competitive wins along with continued strong demand for our antibodies and our Companion Diagnostics services are driving our growth in that segment.

Agilent also received expanded FDA approval for our PD-L1 IHC Companion Diagnostic for metastatic non-small-cell lung cancer. This companion diagnostic will now be used to identify a broader range of patients who may qualify for first-line treatment with KEYTRUDA.

The NASD business continues delivering strong performance with mid-teens growth. We are on-track to bring our second facility on-line. We anticipate the initial production of GMP grade API's by the end of fiscal 2019. Material revenue contributions are expected in Fiscal Year 2020.

Looking ahead to the second half of the year, we're confident that the momentum will continue in our ACG and DGG businesses. For our LSAG business, our outlook for the second half is tempered by our view of continued soft market conditions.

As a result, we're revising our outlook for the full-year, reaffirming our prior EPS commitment while lowering revenue growth. Bob will describe this in more detail but first, a few summary comments.

We now expect to deliver core growth for the year of between 4 and 5 percent. While we're facing market headwinds in our LSAG business, our full-year earnings guidance remains intact. The Agilent team remains firmly committed to meeting our current guidance for earnings growth. Our guidance reflects confidence in the strength of the overall Agilent business model and our ability to drive solid earnings results.

Thank you for being on the call, and I look forward to answering your questions … I will now hand off the call to Bob. Bob?

BOB MCMAHON

Thank you Mike, and good afternoon everyone. In my remarks today, I will provide some additional detail on revenue, walk through the second quarter income statement and some other key financial metrics, and then I'll finish up with our updated guidance for Q3 and the full year. Unless otherwise noted, my remarks will focus on non-GAAP results, and percentage changes will be on a year-over-year basis.

As Mike mentioned, we delivered solid Q2 earnings despite slower than anticipated top-line growth, underscoring the strength of the Agilent financial model and our ability to respond quickly to changing market conditions. Revenue for the quarter was $1.24 billion, with core revenue growth of 4 percent. Reported growth was 3 percent, as currency negatively impacted growth by 320 basis points, slightly higher than expected. This was partially offset by M&A contributing 190 basis points of growth.

As Mike spoke to the business groups' performance for the quarter, I'll provide some additional details around our end markets and regional performance.

Pharma, our largest end market, delivered 2 percent core growth. As Mike mentioned, we continue to see strength in BioPharma, in after-market Services and Consumables, and in our NASD business. However, the slowing of the instrument replacement cycle for small molecule applications led to a softer than expected result.

Chemical & Energy core growth was a strong 6 percent, above expectations and driven by strong low teens growth in services and consumables. All regions grew, led by strength in the Americas.

Environmental & Forensics was up 7 percent. Strength in Forensics was linked to the ongoing global opioid crisis which is driving demand for expanded forensic laboratory capabilities -- more samples and broader screening requirements. The Environmental market grew mid-single digits and continues to be driven by ongoing expansion of testing and oversight in China.

Wrapping up our end-market discussion, core revenue for both Diagnostics and Clinical and Academia and Government both grew 5 percent, while Food declined 3 percent due to softness in the China market.

Geographically, we saw growth in all regions, led by the Americas with 6 percent growth, as conditions in the US continue to be healthy.

Europe, with 4 percent growth, performed better than anticipated, driven by pharma outsourcing trends and continued strong BioPharma investments.

China grew 3 percent. While we had strong mid-teens growth in the ACG business, softer instrument sales in the Food market and small molecule pharma led to lower than expected overall results.

Before I leave revenue, the core growth of our combined LSAG and ACG businesses – while below expectations – was 4 percent in the quarter and we believe compares favorably to the overall analytical lab market growth.

Now turning to the rest of the P&L, Q2 gross margin was 56.0 percent and increased 70 basis points compared to the prior year. We continue to achieve good gross margin improvements through our productivity initiatives and driving continued economies of scale in our ACG services business.

Operating margin was 21.9 percent, up 60 basis points mainly due to disciplined cost management as shifting market conditions became increasingly apparent in the latter part of the quarter.

Additionally, the tax rate was down marginally, and average diluted shares were 321 million.

This led to non-GAAP earnings per share of $0.71 in the second quarter, an increase of 9 percent compared to the prior year and at the midpoint of our guidance.

Before moving to our guidance for Q3 and the full year, I want to touch on a few additional financial metrics on cash flow and on the balance sheet.

Our free cash flow for the quarter was $213 million. We deployed $102 million in the quarter, consisting of $52 million in dividends and $50 million in share repurchases, representing roughly 635,000 shares. Lastly, we ended the quarter with $2.2 billion in cash and $1.8 billion in debt. During the quarter, we also renewed our revolving credit line of $1 billion, which remains undrawn.

With our strong balance sheet position, we will be more active in the second half of the year deploying capital. Specifically, we intend to deploy $500 million for share repurchases, with the majority of that to come in the 3rd quarter. This underscores not only our balance sheet strength, but also our confidence in the future. In addition, we have plenty of capacity for M&A and we have an active business development funnel, although we will continue to remain disciplined in our approach.

Now, let’s turn to our non-GAAP financial guidance for the fiscal year.

As Mike indicated, we’re reducing our core revenue growth outlook for the year. While our expectations for ACG and DGG aren’t changing, our forecast for the second half is tempered by softening market conditions in certain segments on the instrument side of the business. The developments in China, coupled with the continued uncertainty on trade, is creating a more challenging macro environment.

As a result, we are updating our full year revenue guidance to a range of $5.085 billion to $5.125 billion, representing 3.5 percent to 4.3 percent reported growth. Currency is expected to be a headwind of 210 basis points partially offset by M&A. As a result, we’re now expecting core revenue growth in the range of roughly 4 to 5 percent.

Despite reducing revenue guidance, we feel confident holding to our full year earnings per share guidance range of $3.03 to $3.07, representing growth, excluding currency, of roughly 10 to 11 percent and reported growth of 8.6 percent to 10.0 percent.

As Mike mentioned, our EPS guidance reflects confidence in the strength of the Agilent business and our ability to drive earnings through multiple levers. These include disciplined expense management and use of our balance sheet. Based on deploying the additional $500 million towards share repurchase, we are updating our average diluted share count down to 319 million for the year.

Finally, turning to the third quarter, we're expecting revenue in the range of $1.225 billion to $1.245 billion, representing reported growth of 1.8 to 3.5 percent and core growth of 2.7 to 4.1 percent. Currency is estimated to be a headwind of 210 basis points, partially offset by M&A contributing roughly 120 to 150 basis points of growth.

Third-quarter 2019 non-GAAP earnings are expected to be in the range of $0.71 to $0.73 per share, which is 6 percent to 9 percent reported growth versus a year ago. The share count for Q3 is expected to be 317 million.

Before opening the call for questions, let me conclude by saying we were pleased with our team's ability to preserve earnings performance despite shifting market conditions. We are confident in the strength of Agilent's business and our team's ability to navigate softness in certain markets.

With that, before opening it up for questions, I will turn it back to Mike for some closing comments.

<u>MIKE MCMULLEN</u>

Thanks Bob. I just want to add a few closing words before moving into Q&A.

Great companies do not just react to market conditions, they see market opportunity. At Agilent, we will continue to drive productivity and double-down on our efforts to be a more Agile company. We have multiple levers to drive earnings including disciplined expense management and use of our balance sheet. However, we are not going to "expense cut" our way to growth. We will continue to bring innovative new products to market and aggressively compete for market share.

Now, Ankur back to you for the Q&A.