

Company: IntriCon

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Moderator: Scott Longval

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Operator: Good day and welcome to the IntriCon Second Quarter 2017 Results Conference Call.

Today's conference is being recorded. At this time, I would like to turn the conference over to Scott Longval, Chief Financial Officer. Please go ahead.

Scott Longval: Thank you, operator. Joining me on today's call is Mark Gorder, IntriCon's CEO. Before we begin, I'd like to preface our remarks with the customary safe harbor statement. Today's conference call contains certain forward-looking statements. These statements are based on current estimates and assumptions of IntriCon's management, and are subject to uncertainty and changes in circumstances. Given these uncertainties you should not place undue reliance on these forward-looking statements. Actual results may vary materially from the expectations' contained in today's call. Important factors that cause such differences include among others those set forth in the headings Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operations in our 10K filing for the year ended December 31, 2016. With that I'd like to turn it over to Mark for a strategic look at IntriCon's second quarter.

Mark Gorder: Thank you, Scott, and thank you everyone for joining us today. I would like to begin by reviewing key highlights and results for the second quarter. After that Scott will cover the financials in more detail and then we'll be glad to take your questions. By this time most of you had a chance to review our second quarter press release. The company reported record net sales of \$22 million -- up 32.1% from the \$16.6 million in the prior year period. Gains in medical and value hearing health drove the strong performance and we expect that to continue in the third quarter.

In addition we're making meaningful progress in creating and cultivating a new channel to deliver superior outcomes based affordable hearing healthcare directly to consumers. Looking at our three businesses, our medical business increased 45.9% in the 2017 second quarter from the earlier - year earlier period. The gain was primarily driven by the expected production ramp of Medtronic's MiniMed 630G and 670G wireless glucose monitoring systems. In June, Medtronic announced the US launch of the MiniMed 670G system, the world's first hybrid closed loop system for people with Type 1 diabetes.

Medtronic began fulfilling orders from patients enrolled in their Priority Access program which they anticipate will continue into the fall of 2017. In parallel, Medtronic began taking new orders from interested customers who want to be next in line to receive the system after the Priority Access orders are filled. We remain well positioned with Medtronic with 2017 second half sales also expected to be at record levels

Turning to Hearing Health, sales in this business grew 32.5% from the prior year second quarter, primarily stemming from growing traction in our value hearing health initiatives including a 55% growth from HI HealthInnovations and a \$1.4 million contribution from HHE, partially offset by declining conventional channel sales. As previously announced we acquired a 20% stake in DeKalb, Illinois based HHE, a direct to consumer mail order hearing aid provider in the fourth quarter of 2016. In January 2017, we exercised our option to acquire the remaining 80% stake in HHE. That is expected to close during the fourth quarter.

Since taking our initial stake in HHE, we have made substantial progress integrating and optimizing the organization. In 2017, we completed the relocation of the business merging two locations into one, hired Jim Houlihan as Vice President of Direct to Consumer Hearing Health Sales and President of HHE. Enhanced HHE sales and marketing capabilities and increased advertising. And finally, introduced IntriCon's digital hearing devices into the HHE portfolio most recently adding the Apollo 6200, the Apollo 6310, and the Ranger 7610 digital hearing aids.

From a financial perspective, we are seeing great traction in our direct to consumer model. As compared to the 2017 first quarter during the second quarter HHE increased hearing aid orders by 75% grew total backlog 62%, doubled the number of new qualified leads to our database and doubled the number of net new customers to our database. Based on these metrics we intend to increase our investment in advertising in the second half of the year in order to further accelerate growth. While the increased investment will have a minimal impact in 2017 as our HHE hearing aid revenue is deferred two months it will position HHE for more robust growth in 2018. That said, we do anticipate second half revenue to be up 35% over the first half of 2017.

Along with the addition of HHE in April 2017 we entered into an agreement to acquire a 49% stake in Soundperience headquartered in Frankfurt, Germany. Soundperience has designed the first psychoacoustic way of analyzing peripheral hearing and central hearing processing branded as the Sentibo Smart Brain System. The software is a sophisticated self-fitting hearing aid and brain training software technology that is being used in the German market today most notably through IntriCon's previously disclosed Signison joint venture with Soundperience.

Sentibo is currently being integrated with our wireless hearing aids and we anticipate an initial rollout in Germany during the current quarter. In addition to its international application we also view this software as a critical component to our domestic value based hearing healthcare model. Sentibo as well as our other proprietary fitting systems are designed to improve both channel productivity and the quality of first-time fittings resulting in lower prices, greater access and increased customer satisfaction. Just recently we began piloting a cloud based version of the Sentibo Smart Brain system in the United States and anticipate a broader commercial launch in the first half of 2018.

Looking at some - the other international hearing health initiatives we continue to focus sales efforts into the National Health Service Clinics in the UK. While our efforts to make inroads to the

NHS have proven to take longer than expected, in April, we received formal approval from the NHS for a third device, the Kamplex 940D which will enhance IntriCon's sales opportunities. The Kamplex 940D which is a traditional behind the ear device is very appealing to the NHS because of its broad fitting range and advanced features.

During the quarter we identified 12 initial NHS reference sites. We intend to place a qualified IntriCon employee in those NHS clinics to support patient fittings and gather feedback. Once the initial 12 clinics have been engaged we will reach, attract and convert further NHS sites. Our goal is to be delivering 1,000 hearing aids a month to the NHS by the end of the 2017.

Shifting to public policy, there have been significant developments during the first half of 2017. Legislation was introduced in the House and Senate to make hearing aids available over the counter for those with mild to moderate hearing loss. The proposed legislation will require the FDA to write regulations ensuring that this new category of over the counter hearing aids meets the same high standards for safety, consumer labeling, and manufacturing protections as all medical devices providing consumers the option of an FDA regulated device at lower cost.

On July 12, the House of Representatives passed by voice vote HR 2430 the FDA Reauthorization Act which includes the Over-the-Counter Hearing Aid Act of 2017. The legislation will go before the full U.S. Senate for consideration. While no timeline has yet been set for floor vote the Senate is expected to act prior to the August recess. We believe this legislation has the potential to remove the significant barriers existing today that prevent innovative hearing health solutions.

We believe that this legislation would invigorate competition, spur innovation, and facilitate the development of an ecosystem of hearing healthcare that provides affordable and accessible solutions to millions of unserved or underserved Americans. Additionally these public policy

changes all further support our strategic focus to gain direct access to consumers in the underserved market. With that said I'd like to turn the call over to Scott.

Scott Longval: Thank you Mark. I'll begin by reviewing our second quarter financial results in more detail.

In 2017 second quarter we reported net sales of \$22 million -- up 32.1% from the \$16.6 million in the prior year period. The increase was primarily due to year over year revenue gains from our largest customer as well as growing traction in our value hearing health. IntriCon posted net income attributable to shareholders of \$610,000 or 8 cents per diluted share versus a net loss attributed to shareholders of \$1.5 million or 23 cents per diluted share for the 2016 second quarter.

Second quarter gross profit margins were 30% up significantly from 23.1% in the prior year's second quarter. The increase was primarily driven by greater volume and the impact of higher direct to consumer business in 2017 results. Operating expenses for the second quarter was \$6 million compared to \$4.7 million in the prior year second quarter. The increase was largely due to the inclusion of Hearing Help Express in 2017.

In terms of guidance, based on the information that's currently available we anticipate the 2017 third quarter net sales to range between \$22 million and \$23 million which represents an increase of 42% to 48% over the prior year comparable period and positive EPS. For the year we anticipate net sales to range between \$86 million and \$88 million, which is up 26% to 29% over the prior year. Now I'd like to turn the call back over to the operator so we can take your questions.

Operator: Thank you. If you would like to ask a question please signal by pressing Star 1 on your telephone keypad. If you are using a speakerphone please make you're your mute function is turned off to allow your signal to reach our equipment. Again press Star 1 to ask a question, we'll

pause for just a moment to allow everyone an opportunity to signal. And once again that is Star 1 to ask a phone question. Our first question comes from Dick Ryan with Dougherty.

Dick Ryan: Thank you and congratulations on a good quarter guys.

Mark Gorder: Thank you Dick.

Dick Ryan: A question on Medtronic, how much of the business was Medtronic? And I think a few weeks back they talked about some supply issues with their CGMs and I'm wondering if that had any impact on your business or could that in maybe the second half?

Mark Gorder: Yes Dick, good question. For the second quarter Medtronic made up about 49% of our total revenue about \$10.8 million.

Dick Ryan: Okay.

Mark Gorder: And to the second question we saw very little disruption with that hiccup that they had. I know that they're in the process of remedying that. And as we look out for the second half of the year we don't see that having really any impact on our business with them going forward.

Dick Ryan: So second half outlook versus Q2 is it kind of plateau or is there sequential growth from what occurred in Q2?

Mark Gorder: We're anticipating sequential growth in definitely in Q3. And we anticipate it could be in Q4, I think it's a little bit early to speculate there. But clearly that business is strengthened. If you're following any of the news releases that Medtronic has put out they've had a very good reception for the 670G system. And I know that they're starting out to look - to get approval OUS which will only be additive in future periods.

Dick Ryan: Okay. I saw the comment on hi HealthInnovations' growth I don't know are we awakening a sleeping giant or what's going on with that relationship?

Mark Gorder: Well Dick as we've said in past press conferences that even though we were disappointed back with the early take off with hi Health they have made steady continuous progress over the last several -- last few years. And now we're -- we are seeing a slight acceleration. I wouldn't say it's a rocket ship taking off but it's definitely good steady growth that obviously year over year that was pretty impressive percentage increase for them. They are our largest hearing aid purchaser at this point.

Dick Ryan: Are they - do they have their infrastructure in place, the number of audiologists that they need and that sort of infrastructure requirements, do you know?

Mark Gorder: They obviously for them, there's not a lot of restrictions on resources. And from our understanding they are in this business to sell insurance policies and they simply are providing the hearing aids as a benefit to their insurees. So as the number of claims comes in they add to their capacity to meet that requirement.

Dick Ryan: Okay, you mentioned on the DTC side you're going to be looking at increasing advertising expense; can you kind of quantify that effort?

Mark Gorder: Yes, we're very pleased with the initial trials that we have done in terms of experimenting with different media mixes in terms of what produces a best outcome. We think we're zeroing in on a particular formula that produces a very good revenue to advertising ratio. And Jim Houlihan, the VP of Direct to Consumer Business and President down there has a good handle on that. And so based on his recommendation we are going to up the expenditure there. And we anticipate

that, that will result in a good increase in revenue as we said here it won't result in anything meaningful until Q1 of next year but we're going to set the table by...

Dick Ryan: Okay, Scott just a couple of housecleaning who is professional audio? I missed that and depreciation and stock based comp?

Scott Longval: For the third quarter we had or excuse me for the second quarter professional communications was \$1.5 million.

Dick Ryan: Okay.

Scott Longval: For and depreciation was roughly a half a million, and stock based comp was 218 excuse me \$207,000.

Dick Ryan: Okay, thank you.

Scott Longval: Thanks Dick.

Operator: Our next question comes from Ross Strehlow with RBC Wealth Management.

Ross Strehlow: Yes, like Dick mentioned congratulations guys on the quarter, it looks great.

Scott Longval: Thank you Ross.

Mark Gorder: Thank you.

Ross Strehlow: Can you breakdown for me your profitability on the hearing side, how are you doing on that issue?

Scott Longval: Well we currently don't break profitability out by our different business lines. It's a little bit premature to do that. What I can tell you and what we've stressed over a number of calls and public releases is that the medical business is obviously the foundation, it's generating a lot of cash and profitable. And we are using those funds to invest in what we think can be a breakout opportunity on the hearing health side. To Mark's points and comments earlier as we're beginning to invest a little bit heavier on the direct to consumer side we're anticipating to see those topline numbers accelerate and drive the overall hearing health business businesses to profitability and beyond in the short term.

Ross Strehlow: Okay, so again in other words you're still not profitable on the hearing side, is that safe to say?

Scott Longval: Overall I would say that is accurate.

Ross Strehlow: Okay, and so if you can give me an idea of when do you expect that hearing side of the business to become profitable? That'd be great to know.

Scott Longval: Based on what we are planning Ross and with the growth continued growth we see in both the HHE and with other direct to consumer partners that we are developing we anticipate probably by mid-2018 that that business will also be profitable.

Ross Strehlow: Okay. All right, thanks guys. Appreciate it.

Scott Longval: Thanks Ross.

Operator: And as a reminder that is Star 1 to ask a phone question. Our next question will come from Larry Haimovitch with HMTTC.

Larry Haimovitch: Congrats on the quarter guys.

Mark Gorder: Thanks Larry.

Larry Haimovitch: I'm sorry, I joined the call a bit late. I had four other conference calls. So I have been really juggling here. Looking at the press release something that I didn't quite understand and want to try to get a better handle on, quote from Mark Gorder "in second quarter HHE increased hearing aid orders 75% over the first quarter now and then second quarter -- second half revenue be up 35%." I'm trying to understand same store sales apples to apples sales, can you help me understand what the growth rate is not based on when you acquired it but is there some way to look at it from a same store or apples to apples basis?

Scott Longval: Well I think Larry the way that you're looking at it to the way that we laid out is a pretty good representation. So we do have a little bit of delay from revenue recognition to the increased hearing aids orders. There's a two-month delay based on a warranty period that we provide. So orders that were shipped in May and June will be recognized here in July and August and so forth.

As we would step back and look at the business and the key metrics that are important to us to ensure that we're driving this business forward is what are the current hearing aid orders? And we saw a significant increase in the second quarter Mark quoted the 75%. The other component to that business that you're not seeing here is there's a large battery component to that business. It makes up roughly 40% of the overall revenue, 35% to 40%. And that is not growing quite as rapidly as the hearing aid business because we're really more focused on growing device sales and not battery sales at this point.

Mark Gorder: And I would add to Scott's comment but Larry that some of the -- in the call here we indicated not just the increase in hearing aid orders but we're starting to publish some predictive measures like the backlog, the number of new qualified leads because obviously you need qualified leads in order to get orders. So those are all those numbers have to be increased in order for us to drive revenue. So we're going to start talking about those numbers on a consistent basis now and if we continue to increase those numbers you'll see a continued increase in revenue on a quarter over quarter basis.

Larry Haimovitch Okay, well that's very helpful. Guys with all due respect to your brilliant management abilities this 75% increase in hearing aid orders is probably not what the growth rate was before you acquired the company. I don't know exactly what it was but I don't think they were growing anywhere near 75% so what accounts for the fact that since you acquired it all of sudden this business is just going, going to the moon. I mean this is quite an impressive...

Mark Gorder: Well there's a couple of...

Larry Haimovitch: Go ahead.

Mark Gorder: ...first it's a huge untapped market when you look at the penetration of the conventional channel into the market according to the statistics that the government is using in this legislation our penetration is only at 14%. And we've got an aging population and affordability and access are huge barriers. So by getting professional management at HHE which Jim Houlihan right now represents and he's applying very sound marketing principles to drive new leads, convert those leads, and generate orders that's why we're seeing this tremendous increase because we're coming from a base where we didn't have that kind of management in there to one where we do.

And the market is untapped and very large. So, we don't know to what level we can continue to scale and drive this but to the extent that we can increase advertising and continue to get a good

result we'll continue to do that. So what we'll probably show you guys is we'll continue to report these predictive measures and we will continue to report that based on what we're seeing we're going to increase the advertising quarter over quarter. So now we're going to take a particular - we're going to increase it to a particular level and see what kind of result we get. And if we keep getting growth results we'll keep increasing the advertising.

Larry Haimovitch: So what I'm hearing is same Mark is you guys are putting more professional management to run the business as well as increasing marketing expenditures to bring business in. Is that a fair characterization of what you just said?

Mark Gorder: Yes. And then we're backing that up with support from IntriCon by putting in all the state of the art digital products. So we've significantly increased the quality of the products at HHE as well.

Larry Haimovitch: Okay, regarding Jim Houlihan it's great to see you've brought someone on board, it took an awfully long time to come to that decision, why did it take so long?

Mark Gorder: Well we acquired the - we didn't really acquire the business until November and at that time we hired Jim as a consultant to come in and stabilize the business. And it turned out that not only was Jim a great stabilizer he was also the right person for the permanent position. So you could argue it might have taken us a quarter too long to actually get the -- get him in place but at the end of the day we got the right person in there.

Scott Longval: Yes, I'll just echo those remarks from Mark. If you recall when we first took over we needed someone to provide some professional leadership. And the first things that Jim needed to do was get his arms around that business and also had a lot of administrative things to do, relocating the business, right sizing the business, et cetera. But that the skill set that we needed most was expertise in online marketing, digital marketing, and it was over the last I would say six

months that Jim really displayed his abilities to do those skill sets and very efficiently and effectively as you can tell in some of the numbers we publish. So, you know, we wanted to take our time make sure it was the right add. It's a critical position for us going forward and we're happy to have Jim on board.

Larry Haimovitch: Right. One more question and I'll jump back in the queue. Will you cash flow positive in the quarter.

Scott Longval: We were.

Larry Haimovitch: Okay, how much was it?

Scott Longval: Generated about \$2 million of EBITDA.

Larry Haimovitch: Okay, great. And free cash something less than that?

Scott Longval: Correct yes.

Larry Haimovitch: Okay because I was looking at your balance here the cash and restricted cash number is fairly low not that you've ever been cash rich company but I've got to think that running the business as it's growing so much with, you know, about a million dollars of cash is a little bit comfortable for you Scott being the CFO.

Scott Longval: It's a little bit of a challenge but I'll say this we've, you know, been very fortunate that we've seen a lot of strength in our base medical business in other pockets that's generated a lot of cash that's allowed us to be aggressive in pockets where we wanted to drive the value hearing health.

Larry Haimovitch: Great thanks. I'll jump back in queue.

Scott Longval: Thanks Larry.

Operator: And we'll take a follow-up question with Dick Ryan from Dougherty.

Dick Ryan: Thank you. Say Mark on the NHS side just a couple of things you want to get to I think you said what a 1000 hearing aids a month. Can you give us a perspective of where that is today? But I thought you said you were going to add one dedicated employee in 12 sites. And I mean first what's the -- what's your headcount over there now and how much did the PC Werth contribute in the quarter?

Mark Gorder: We don't need to have 12 people out there. We got everybody in place that we need and it's a matter of just sending them to the clinics for three or four days for intense training. So we have selected 12 clinics. And our goal is to get 100 hearing aids per month out of 12 clinics by the end of year. And we think that's doable, we've got the right products over there now and we've got the right sales people in place so we're not adding any more people to do this.

Dick Ryan: And what was PC Werth's contribution in the quarter?

Scott Longval: About \$800,000.

Dick Ryan: Now is that much hearing aid business or is it more their testing and accessories.

Mark Gorder: Most all that's test equipment and accessories.

Dick Ryan: Okay.

Mark Gorder: But all - but majority of it going to the NHS.

Dick Ryan: Okay all right.

Mark Gorder: It's hearing related that's not hearing aid related.

Dick Ryan: Okay great. Thank you.

Mark Gorder: Thanks Dick.

Operator: It appears there are no further questions at this time. I'd like to turn the conference back to Mark Gorder, CEO for any additional or closing remarks.

Mark Gorder: Thanks. Once again we appreciate your taking time out of your day to join the call. In closing I'd like to reiterate that I'm excited with the direction we are headed we delivered a strong first half and the future looks bright. As our medical business thrives we're also gaining critical momentum in value hearing health and we continue to believe that this effort will dry success for IntriCon and deliver value for our shareholders. We look forward to sharing our successes with you in the future and thanks again for joining the call.

Operator: And that does conclude today's conference. We thank you for your participation.