

## Company announcement no 2014-07

13 November 2014

Interim information, third quarter

### **Turbulent US market drives Oticon unit growth in the US at lower prices Earnings guidance reduced by 3% to reflect US market development Transition into a leading global hearing healthcare company continues**

- The Group's core business – wholesale of hearing aids – realised unit growth of 8% year-to-date. Apart from the increased pricing pressure in the US, all our business activities have developed satisfactorily and in line with our plans.
- The addition of one manufacturer's premium hearing aid brand to a big box retailer in the US has created turbulence in the US hearing aid market. This has resulted in lower selling prices of Oticon products in the US, but also growing sales to independents, though such sales are partly offset by a reduction in Bernafon's unit sales to a big box retailer.
- In the third quarter, our retail activities generated satisfactory revenue growth, especially in Europe and Australia. In connection with the consolidation and integration of our US retail activities that followed the acquisition of numerous minor entities in the period from 2011 to 2013, we have standardised the financial procedures in these minor US entities. In this process, we have identified inaccuracies in certain balance sheet items with an isolated adjustment effect in 2014. Combined with an expected loss on a customer loan in the US, this leads to a total one-off adjustment of our EBIT in 2014 of around DKK -100 million.
- In the period under review, Oticon Medical continued to deliver double-digit sales growth rates exceeding market growth rates, both in bone-anchored hearing systems (BAHS) and in cochlear implants (CI). Oticon Medical continues its expansion in R&D and has increased its market reach. Major product launches are planned for 2015.
- Our Diagnostic Instruments business activity has improved the delivery bottlenecks caused by the transfer of production to a new manufacturing facility and by the upgrade to a new ERP system. In the past quarter, we have thus been able to ship more orders from our strong order book, generating significant organic growth, and we expect this positive trend to continue into the fourth quarter.
- The Group's earnings guidance has been reduced by 3% to reflect the US market development. Therefore, we now forecast a rise in earnings per share (EPS) of 2-7% (excluding the impact of one-off balance sheet adjustments) against previously 5-10%.

#### **Market trends**

In the third quarter, unit growth on the global market for hearing aids is estimated to have exceeded the Group's general assumption of 2-4% unit growth in the market.

The US market saw a mid-single-digit unit growth rate in the third quarter, bringing year-to-date unit growth to the normal historical growth level. Once again, unit growth in Veterans Affairs (VA) exceeded unit growth in the private sector. The US market is currently turbulent, and we are seeing new dynamics in a hearing aid market that has historically been characterised as stable. These new trends seem to be a consequence of one manufacturer's decision to offer its premium brand to a big box retailer and the turbulence this decision has caused in other channels – especially in the independent channel. Furthermore, we have for several years seen high growth rates in VA and in big box retailing, resulting in no growth – or maybe even negative growth – in the independent channel in the US. The new market conditions in the US are characterised by lower average selling prices caused by channel mix shifts and increased price competition.

In the third quarter, we believe that in overall terms, unit growth in the major European markets for hearing aids has been higher than the historical average. Due to low sales in the third quarter of 2013, Germany continued to show above-normal growth rates, however at a slower pace than in the previous three quarters, and has now entered the fourth quarter with more demanding comparative figures. The demand pattern of the NHS in the UK tends to fluctuate on a quarterly basis, and despite strong year-to-date growth, the third quarter was weak.

All in all, we estimate that in terms of value, the global market for hearing aids has seen flat to modest growth in the third quarter.

### **Hearing Instruments**

The Group's core business – wholesale of hearing aids – has year-to-date delivered a satisfactory unit growth rate of 8%, and this positive unit sales momentum has continued into the fourth quarter. As expected, this satisfactory unit growth was mainly driven by products based on the Oticon Inium platform – especially in the mid-priced and low-end product categories. We have been able to take advantage of the current opportunities caused by the turbulence in the US market due to a competitor's decision to offer their premium brand to a big box retailer, and much of our growth has thus been in the independent channel. On the other hand, Bernafon sales were below expectations, mainly due to the loss of market share with a big box retailer in the US.

As a consequence of the turbulent market conditions in the US, the Group's selling prices in the US were reduced in the third quarter – and in fact more than previously expected. We are closely monitoring the trends in the US wholesale market for hearing aids. In case the market dynamics in the US are not only temporary, we will in the period up to the release of our Annual Report 2014 consider taking certain initiatives with a view to optimising our core business, thereby addressing the market changes.

Oticon's launch of competitive design instrument styles in September is progressing very well, and the additions to the Alta, Nera and Ria families have reinforced our unit growth momentum. The new styles perfectly meet the demand for discreteness by first-time users, while offering all the audiological features and wireless capabilities of the very power-efficient Inium platform using small 10A batteries. At the recently held EUHA congress in Hanover, Germany, Bernafon showcased its upcoming high-end product Juna. The product is a significant strengthening of the Bernafon product portfolio and should help Bernafon regain some of their sales momentum.

In the third quarter, our retail activities generated satisfactory revenue growth in line with our expectations, and growth rates in Europe and Australia, in particular, were encouraging. The gradual improvement we have seen over the past year can, among other factors, be attributed to the implementation of optimised business processes, and this improvement has continued into the fourth quarter. In general, traditional retailing in the US is impacted by the presence of big box retailers, and we too experience this in our own US retail activities.

### **Oticon Medical**

The Group's ongoing transformation from mainly being a hearing instrument company to becoming a broader and even more growth-oriented hearing healthcare company is a central part of our overall ambition and strategy. To achieve this, Oticon Medical's journey towards becoming a leading global implant company based on strong positions in bone-anchored hearing systems (BAHS) and cochlear implants (CI) plays a crucial role. For many years to come, the solid growth outlook in the implant market combined with our opportunity to gain significant market shares will strengthen the Group's overall growth profile. However, the expansion of our implant activities will naturally increase Oticon Medical's costs in the short to medium term, especially since we have chosen to primarily build these businesses organically.

Again in the third quarter, Oticon Medical delivered double-digit sales growth rates, exceeding market growth rates, both in BAHS and in CI. Oticon Medical continues its expansion in R&D and has increased its market reach by virtue of distribution power. Major BAHS and CI product launches are planned for 2015. Neurelec has been successfully integrated into Oticon Medical, and the next CI system will be launched under the Oticon Medical brand in 2015. In our Annual Report 2014, we furthermore intend to present the revenue generated by Oticon Medical separately along the same lines as disclosures made in respect of our Hearing Devices and Diagnostic Instruments business activities.

### **Diagnostic Instruments**

Our business activity Diagnostic Instruments has improved the delivery bottlenecks caused by the transfer of production to a new manufacturing facility and by the upgrade to a new ERP system. In the third quarter, we have thus been able to ship more orders from our strong order book, generating significant organic growth, especially in balance equipment and clinical audiometers. Going into the fourth quarter, we see continued strong momentum and expect to gain further market shares.

### **Other business areas**

In the third quarter, Sennheiser Communications delivered very satisfactory growth in revenue and earnings driven by the Call Center and Office (CC&O) sales generated in especially Europe and the US. The Unified Communication part of the overall business is increasing, and this trend is expected to continue going forward. The Group's implementation of new IFRS accounting standards on 1 January 2014 eliminated the option of proportionate consolidation of joint ventures, including Sennheiser Communications. However, Sennheiser Communications will continue to contribute to Group earnings, and we will continue to provide relevant information on this business.

## **Other matters**

### *Consolidation of US retail*

Following a period of expansion of our US distribution activities due to a high number of minor retail acquisitions in the period from 2011 to 2013, we have now entered a phase of consolidating and integrating these retail activities. Most of the acquired entities have their own operating processes, IT systems, financial accounting systems etc., and the integration into one common system is crucial in order for us to be able to run an efficient business. While consolidating and standardising the financial procedures of the 70-80 acquired retail entities in the US, we have identified inaccuracies in the balance sheets of some of these entities, leading to adjustments of certain balance sheet items in the acquired businesses.

Furthermore, we expect to incur a loss on a customer loan in the US. The expected loss relates to a non-current loan given to an optician chain to support its expansion into hearing instrument retailing. The optician chain went bankrupt, and subsequently, it has not been possible to take over the business, as we would normally do with a hearing aid retailer.

Each of the two one-off adjustments amounts to around DKK 50 million, and the total amount of around DKK 100 million will negatively impact the Group's operating profit (EBIT) in 2014. In our Annual Report 2014, these one-off adjustments will be described in more detail, once we have further investigated and corrected the issues identified. However, these one-offs have already now caused us to further tighten the financial procedures in such acquired entities and also underpin the importance of further consolidation into one common finance and IT system. It is our clear impression that we have now identified all major balance sheet inaccuracies and that the risk of additional one-offs in this part of our business is limited.

### *Capital structure*

As of today, the Company has in 2014 bought back a total of 1,479,635 shares worth DKK 707 million, bringing the total number of treasury shares up to 1,681,160, corresponding to 2.97% of the share capital.

As mentioned in our Interim Report 2014 (first half-year), we expect continued strong cash flow from operating activities, but rather limited acquisition and investment opportunities in the near future. In the period from 2014 to 2016, the Company consequently plans to buy back shares worth DKK 2.5-3.0 billion of which shares worth DKK 0.8-1.0 billion are expected to be bought back already in 2014, including the shares worth DKK 707 million repurchased year-to-date. In the period from 2014 to 2016, we thus expect to see a modest and gradual increase in the Group's gearing multiple towards a level of 1.5, measured as net interest-bearing debt relative to EBITDA. Should attractive acquisition or investment opportunities present themselves during this period, the Company will reconsider the targeted gearing level and the announced buy-back programme with a view to ensuring a high level of financial flexibility and value creation in the Group.

## **Outlook for the 2014 financial year**

In 2014, we expect to deliver continued growth in both our business activities. Acquisitions are expected to contribute by 3-4% to Group revenue in 2014, mainly driven by acquisitions made in 2013.

Based on foreign exchange levels in late February, more than half of the positive impact of acquisitions will be offset by changes in exchange rates.

In consideration of a weakened set of invoicing currencies compared to 2013 as well as gains from our hedging activities, exchange rates based on February currency assumptions are expected to negatively affect the Group's operating profit (EBIT) in 2014 by around DKK 100 million. Of this amount, DKK 60-70 million were realised in the first six months. Since the end of the first half-year, several of the Group's invoicing currencies have gained strength, and if these higher levels remain for the rest of the year, the negative impact of exchange rates on our operating profit (EBIT) in 2014 will be materially lower than we initially anticipated.

In 2013, the Group once again generated a strong cash flow, reflected in a cash conversion ratio (CFFO/EBIT) of 73%. Also in 2014, we expect to deliver a high cash conversion ratio. Keeping in mind that our near-term acquisition opportunities are rather limited, we expect to be able to buy back Company shares worth DKK 0.8-1.0 billion in 2014 as mentioned in our Interim Report 2014. In order to maintain a high level of flexibility, this level of share buy-back is subject to change, should additional attractive acquisition opportunities present themselves.

The turbulent US hearing aid market has resulted in lower selling prices of Oticon products in the US, but also growing sales to independents, though such sales are partly offset by a reduction in Bernafon's unit sales to a big box retailer. The Group's earnings guidance has been reduced by 3% to reflect the US market development. Therefore, we now forecast a rise in earnings per share (EPS) of 2-7% (excluding the impact of one-off balance adjustments) against previously 5-10%.



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