

# Cochlear Limited

## 2016 Annual General Meeting

### Chairman's Address

**18 October 2016**

**Rick Holliday-Smith** Chairman

Ladies and gentlemen...

The financial year to 30 June 2016 was one of steady progress and underpins the Company's long-term objectives.

#### **Financial results**

Cochlear reported a record net profit of \$189 million in FY16, an increase of 30% on the FY15 full year result.

It has been a significant year for Cochlear with incoming Chief Executive Officer & President, Chris Smith, transitioning into his new role, injecting a sharper focus on the customer and market growth activities while maintaining the Company's strong commitment to product development and innovation.

The positive momentum we saw in FY15 continued throughout FY16 with growth delivered across all product categories and regions. The business achieved a major milestone with sales revenue exceeding \$1 billion for the first time.

It was encouraging to see the progress made throughout the year, with the suite of products launched over the past few years, across all product categories, laying the foundations for solid sales and earnings growth.

In FY16 we introduced a number of new products including Cochlear's first off-the-ear sound processor Cochlear™ Kanso™, and Baha® 5 Power and SuperPower. We introduced the Nucleus® Profile™ Slim Modiolar, the world's slimmest electrode, and launched the next generation True Wireless™ Mini Microphone 2+.

Cochlear continues to demonstrate its commitment to being the technology leader in our industry with ongoing investment in research and development (R&D). Our aim is to improve hearing outcomes and expand the indications for implantable solutions so our recipients can have the quality of life they expect.

In FY16, R&D spend increased to \$143 million, representing approximately 12% of sales revenue. As we move forward, we are injecting greater discipline into our R&D processes to ensure our investments are customer-driven and returns focused. We expect to deliver new products across all categories over the next 18 months, as well as advancing our long-term technology development pipeline.

The Services business, which includes sound processor upgrades and accessories, continues to perform well and now represents approximately 25% of sales revenue. This year we established Services as a separate business unit with its own President, reporting to the CEO. We expect its sales contribution to continue to trend upward over time as both the recipient base and our service offerings expand.

The solid earnings growth, combined with strong free cash flow, has supported a 21% increase in dividends. The dividend payout ratio is 70% of net profit and this year is fully franked. This level is in line with the Board's target dividend payout of around 70% of net profit.

During the year we have benefitted from the devaluation of the Australian dollar. We have also taken the opportunity to accelerate our investment in market growth initiatives, including direct-to-consumer marketing and expansion of the sales force, as well as increasing our investment in R&D. We believe these investments, in previous years, have contributed to market growth this year and will help underpin growth in the coming years.

### **Financial outlook**

In FY16, and again in FY17, we provided earnings guidance for the Company. We recognise that, with an expanding portfolio of products, a broad market coverage in developed and developing countries, and the related exposure we have to currency movements, providing earnings guidance gives shareholders a clear indication of the financial performance expectations that the management team has for next 12 months.

For FY17, we expect net profit to be within a range of \$210-225 million, an increase of between 10-20% on FY16.

### **Innovation**

I now want to discuss innovation, a subject that is very important to Cochlear.

Much has been said recently in Australia about innovation, and Cochlear broadly supports the National Innovation and Science Agenda that the Government announced last December. The Ferris, Finkel and Fraser Report states that "R&D activities are a key driving force of productivity and economic growth". We agree, which is why we continue to be active in the public debate around proposed changes to incentives.

Cochlear spends about \$140 million a year on R&D related activities. This is a significant investment, amounting to 12% of our revenue, with the majority of our R&D occurring here in

Australia. As a consequence, while 95% of our revenue is generated outside Australia, we pay over 75% of our taxes in Australia.

Importantly, the valuable Intellectual Property, or IP, generated from this R&D is largely owned in Australia. And by conducting these activities here, we are also providing a training ground for leaders of the next generation of innovators, especially in the field of medical technology.

Cochlear has benefited from the government's R&D tax concession, generating until recently an annual tax benefit of about \$10 million. This incentive aims to encourage globally mobile, export focused, advanced manufacturing companies like Cochlear to stay in Australia to the fullest extent possible. It has also been a contributing factor to Cochlear's decision to conduct the majority of its research in Australia.

We note that Australia is now reducing these R&D incentives at a time when many other countries appear to be increasing incentives to attract R&D investment. Recent changes announced as part of the omnibus bill, as well as further proposed changes, will materially reduce the R&D tax benefits to Cochlear in Australia.

Unfortunately, the impact of these decisions can only be fully understood over the longer-term. There may be little or no apparent impact from changes to taxation policy in the first year, but over time we may see the loss of an increasing amount of research investments to overseas jurisdictions.

Cochlear will continue to vigorously promote the maintenance of a globally competitive R&D tax concession regime in Australia. We believe it is in the best interests of Cochlear and Australia. Australia needs leaders in export oriented businesses, and Australia should encourage research-oriented companies like Cochlear that are involved in advanced manufacturing.

## **The Board**

I will now turn to Board matters. In line with my comments last year, we have implemented a Board renewal process. Our new directors have performed well.

During FY16 we involved an external consultant to independently review the functioning of the Board and to do an individual assessment of each director. The final report was positive and covered areas including backgrounds, experience, tenure, performance oversight, and with senior management involved a 360 degree review. In my view it was comprehensive, objective and valuable.

We discussed and recognise the importance of undergoing a regular process of renewal and from 2017 we will commence another process of Board renewal, ensuring we have a smooth transition of longer-serving Board members over the next few years.

## **Retirement of Chief Financial Officer**

In September we announced that our long-serving Chief Financial Officer, Neville Mitchell, will retire by the end of the current financial year.

In his 26 years as CFO, Neville has made a significant and lasting contribution to building Cochlear. He was part of the team that floated Cochlear in 1995 with a market capitalisation of \$125 million and has been an integral part of building Cochlear into a global market leader with a marketcap of over \$8 billion today. On behalf of the Board, I would like to thank Neville for his valuable service over the past 26 years and to wish him well for the future.

We have commenced the search process for the new Chief Financial Officer which will include both internal and external candidates. The Board will seek to ensure an orderly transition during the second half of FY17 to the new CFO.

## **CEO residency**

In other executive matters, after a year of commuting, our Chief Executive Officer & President will be residing in the US going forward. While it was intended that he be based in Australia, he will continue to reside in the US for family reasons. Given the global reach of Cochlear, the CEO role travels extensively, with Chris Smith spending as much time in the US as he does in Australia. As such, the Board does not believe this change will be disruptive. It is important however to stress the commitment we have to maintaining our Australian base. Chris' situation is considered to be unique. It is certainly intended that future CEO's will be based in Australia.

## **Shareholder transparency**

Transparency and openness with shareholders is important and we continue to strive to improve in this area.

In FY16 we published a number of online shareholder reports aimed at improving transparency and making information easier to access. Cochlear's Corporate Governance Statement, Tax Contribution Report and Investor Handbook have been published and are all available on our website. We expect to expand the range of reports available over the coming years.

## **Our employees**

And finally, I would like to acknowledge the contribution of each of our 3,000 employees. Their knowledge, expertise and passion is key to our future and their focus on delivering excellence for our customers is an important part of our success and our market leadership position.

As a Board, and on behalf of you, our shareholders, I congratulate and thank all of Cochlear's employees for their outstanding efforts and contributions this year.