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ATEC - Q3 2018 Alphatec Holdings Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 08, 2018 / 9:30PM GMT



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CORPORATE PARTICIPANTS

Jeffrey G. Black *Alphatec Holdings, Inc. - Executive VP & CFO*

Patrick S. Miles *Alphatec Holdings, Inc. - Executive Chairman & CEO*

Terry M. Rich *Alphatec Holdings, Inc. - President, COO & Director*

CONFERENCE CALL PARTICIPANTS

Brooks Gregory O'Neil *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Scott Gambill

PRESENTATION

Operator

Good afternoon, everyone, and welcome to Alphatec's Third Quarter 2018 Conference Call. We would like to remind everyone that participants on the call will make forward-looking statements. These statements are based on current expectations and are subject to uncertainties that could cause actual results to differ materially. These uncertainties are detailed in documents filed regularly with the SEC.

During this call, you may hear the company refer to reported amounts, which are in accordance with U.S. GAAP as well as non-GAAP or pro forma measures. Reconciliation of non-GAAP measures to U.S. GAAP can be found in the supplemental financial tables included in the press release, which identify and quantify all excluded items and provide [management's views] of why this information is useful to investors. Joining us on the call today will be ATEC's Chairman and CEO, Pat Miles; President and COO, Terry Rich; and CFO, Jeff Black.

Now I'll turn the call over to Pat Miles.

Patrick S. Miles - *Alphatec Holdings, Inc. - Executive Chairman & CEO*

Thanks, Rishi, and welcome, everyone. We're pleased to report our results for the third quarter, which demonstrate continued transformation. Total U.S. commercial revenue was \$21 million, up 3% compared to the second quarter of 2018. The sequential growth is a testament to the strength of our results given the historical third quarter seasonal weakness in spine.

We continue to see solid progress on our path to accelerated growth, as evidenced by several major accomplishments. Our U.S. commercial business achieved year-over-year revenue growth for the first time since we began the process of reducing nonstrategic distributor relationships in 2017. Secondly, our team started making its mark on ATEC portfolio with the new product Alpha releases. Additionally, we obtained financial independence from an industry competitor with a new term loan that will free up \$27 million over the next 3 years. Terry will go into the demographics of revenue growth, and Jeff will provide detail on a debt refinancing in a moment.

Turning to guidance. We now have greater clarity into how the remainder of the year will progress and are updating our 2018 revenue guidance to a range of \$92 million to \$95 million compared to our previous guidance of approximately \$95 million. This guidance reflects anticipated fourth quarter domestic growth of greater than 10% on both the sequential and year-over-year basis.

Over the past decade, the industry's leading innovators have been the pure-play spine companies. Their focused commitment has been rewarded with revenue growth that has exceeded the broader market. The team that drove much of the innovation now resides at Alphatec. We continue to add profound spine experience with the employment of Mark Ojeda, to lead our cervical and biologics effort. Mark has a proven track record integrating multiple technologies into highly differentiated procedural solutions and has particularly deep know-how building cervical and biologics businesses, 2 segments of the market.



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I'm incredibly excited about the addition of Mark to our team. He will be a tremendous asset to ATEC. Mark, like the rest of us, came to ATEC because of the opportunity to drive meaningful industry-leading innovation in an environment that allows us to move quickly and nimbly. We are focused purely on spine, applying our expertise to a market that we help mold.

To that end, we are prioritizing 3 key initiatives that we know will create value for all stakeholders. Those are creating clinical distinction, revitalizing our sales channel and compelling surgeon adoption.

Let me first describe how we are creating clinical distinction. The opportunity to improve spine surgery remains vast. Surgeons yearn for interoperable information that will drive better decision-making. Other market players are addressing that need with robotics and capital equipment that demand huge physical footprints in the OR, an already severely limited space. Our answer is [Alpha Informatics], a small Bluetooth-enabled platform that will deliver better, more relevant, real-time information.

Additionally, we are developing next-generation access systems, implants and biologics that we'll seamlessly integrate into Alpha Informatics to enable elegant, minimally disruptive solutions regardless of approach. The first future set of Alpha Informatics will be advanced, automated neuromonitoring powered by SafeOp, which we submitted to the FDA during the third quarter.

Currently, over 80% of our revenue is generated by products that were developed and launched in or before 2016. We expect that mix shift -- that mix to shift going forward as we bring next-generation products to market. That starts with 12 Alpha launches on track to be delivered in 2018.

Let me discuss several exciting developments on that front. During the third quarter, we Alpha released our procedure-specific identity collection of porous titanium interbody implants, which have been very well received. The implants utilize an innovative technology that has been designed to enhance bone growth, better manage implant biomechanical performance and deliver improved -- an improved imaging signature.

In September, we received 510(k) clearance of our OsseoScrew system, a next-generation expandable posterior fixation implant designed to restore the integrity of the spinal column in patients with advanced thoracolumbar tumors. The system has been used successfully in thousands of procedures internationally. And with its debut this quarter, it will become the first of its kind domestically. With all of the exuberance about expandable devices in the anterior column, we think that OsseoScrew can help redefine the posterior fixation market.

We are equally excited to be on track with the -- with next week's Alpha release of our next-generation comprehensive thoracolumbar fixation system. With a substantially expanded offering that will distinguish itself in minimally disruptive and open techniques, the systems seamlessly integrates into ATEC spine procedure and will serve as another strong foundation as we shift toward proceduralization.

Looking to 2019 and beyond, we intend to lead the industry in innovation by releasing 8 to 10 new products each year. Our growth potential will compound as these products drive greater surgeon adoption while increasing the number of ATEC products sold into each procedure. Our belief is that few, if any, other spine companies are capable of driving that level of meaningful innovation, a fact that will not be ignored by surgeons.

With that, I will hand the call over to Terry.

Terry M. Rich - Alphatec Holdings, Inc. - President, COO & Director

Thank you, Pat, and good afternoon, everyone. As Pat mentioned, our U.S. commercial business achieved year-over-year revenue growth for the first time since we began the process of reducing nonstrategic distributor relationships in early 2017. It's exciting to see the revenue growth from our expanding dedicated sales channel and surgeon adoption begin to outpace revenue losses associated with that transition.

Now I'll turn to our second strategic priority, revitalizing our sales channel. We continue to partner with more clinically focused, higher-volume, dedicated distributors and direct sales teams. In the third quarter, we expanded the percentage of U.S. commercial revenue driven by dedicated distribution partners to 63%, up from 40% at the end of 2017.



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Year-to-date, the revenue driven by the dedicated portion of our network has almost tripled compared to the first 3 quarters of last year. We also continue to solidify our sales leadership team by leveraging both the excitement about ATEC in the field and the ongoing desire of sales talent to move to companies focused on winning market share through innovation.

The third quarter additions of Emory Rooney, Darrell Wilson and Mason Zabel bring decades of spine experience to the team. Each of them has a proven track record of driving surgeon adoption and building high-performance teams without the benefit of a highly differentiated portfolio. I look forward to seeing what they will accomplish when backed by innovation.

Our third strategic priority is driving surgeon adoption of the ATEC portfolio, a complex endeavor considering the legacy portfolio's limited differentiation. The surgeons who are partnering with us today recognize and believe wholeheartedly in our team's ability to deliver meaningful clinical distinction. As a result of that conviction and the surgeon interest that our enhanced sales channel is driving, a record number of surgeons visited ATEC headquarters to participate in our educational programs during the third quarter.

Importantly, conversion of these new relationships is both strong and accelerating. Third quarter revenue attributable to new surgeon customers continued to substantially outpace overall revenue growth. Also, the ramp of new surgeon relationships has accelerated in each quarter this year. We are demonstrating clear progress against the initiatives that we believe will reposition this organization and accelerate growth.

I'll now turn the call over to Jeff.

Jeffrey G. Black - Alphatec Holdings, Inc. - Executive VP & CFO

Thank you, Terry, and good afternoon, everybody. Third quarter U.S. commercial revenue was \$21 million, up 3% sequentially. And our dedicated distribution channel achieved sequential revenue growth of about 14%, significantly outpacing overall revenue growth. U.S. gross margin was 70.1% in the third quarter compared to 69.5% in the second quarter, in line with our expectations.

Our non-GAAP operating expenses, which exclude restructuring, stock-based compensation, transaction-related expenses and fair value adjustments, were \$20 million in the third quarter compared to \$19.4 million the second quarter. And we continue to drive expense rationalization across all business functions, particularly in G&A. Excluding stock-based compensation and litigation-related costs, our G&A has been relatively flat over the past 3 quarters. But at the same time, we're investing in areas of the business that we expect to drive accelerated commercial growth, particularly product development and sales and marketing. And as a result, our operating expenses have increased relative to 2017.

We ended the third quarter with just over \$35 million in cash. Our cash burn in the quarter included \$1 million in final cash purchase price adjustments or -- I'm sorry, purchase price payments to SafeOp shareholders for our March acquisition and \$833,000 for our first principal payment on our 2016 term loan, which we've now retired in full. Excluding total debt service and our SafeOp shareholder payments, operating cash usage in the quarter was \$6.4 million.

With the proceeds from the \$35 million and financing from Squadron Capital that we announced today, we retired our \$29.2 million term loan. This new financing not only frees us from financial dependence on a competitor, but it also reduces our cost of debt capital by roughly 5% and pushes out amortization by an additional 30 months. Our debt service cash requirements will be reduced by almost \$27 million over the next 3 years, significantly enhancing our flexibility during a critical time for growth-related investments. We're pleased to be partnering with Squadron, a long-term strategic investment.

We'll now turn the call over to Pat for closing comments.



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Patrick S. Miles - *Alphatec Holdings, Inc. - Executive Chairman & CEO*

Thanks, Jeff. I recently celebrated my first year anniversary at ATEC. As I look back over the past year, I'm exceedingly proud of the progress we have made with this transformation. When I started, I said the spine market needs a new ATEC. And over the course of the year, the groundwork that we have laid to create value in spine has increased my conviction in the market opportunity in front of us.

In just 1 year, the collective know-how of this team has already begun to create clinical distinction. We acquired the SafeOp technology to enable unprecedented automated information and to drive real-time interoperative decision-making across all ATEC procedures. We have successfully worked with the FDA to expediently clear multiple products and are on track to launch 12 new Alpha solutions in 2018.

We made great strides in transforming the sales channel, doubling the percentage of the channel that is dedicated and nearly tripling the revenue generated by that group. Those efforts have improved surgeon adoption, driving a meaningful increase in revenue derived from the new surgeon relationships over the course of the past year.

As a result, revenue has begun to grow sequentially. Certainly, there's still a lot of work to do. But when I look at what we've accomplished in a year, it is no secret why there is absolutely palpable undercurrent of enthusiasm for ATEC within the spine market. Spine's greatest expertise has begun to create an organic innovation machine, a machine capable of launching 8 to 10 new solutions each year and repositioning this organization at the very forefront of clinical distinction.

The track record of this team confirms that a relentless focus on improving spine surgery will drive sustainable growth. The stage is set. We are just beginning to pioneer profound innovation in a market that is absolutely ripe for it.

I'll now turn the call back over to the operator, and we will take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Brooks O'Neil from Lake Street Capital.

Brooks Gregory O'Neil - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

Congratulations on all you've accomplished so far. I'm excited about the future. So my first question, I was hoping that you might discuss just a little bit how your [Alpha Informatics] from your SafeOp acquisition is going to change within the OR, the operation of spine surgeons, while they use your equipment?

Patrick S. Miles - *Alphatec Holdings, Inc. - Executive Chairman & CEO*

Yes, Brooks. Thanks very much. It's -- I think what we see is that surgeons are yearning for information, and they're yearning for information that's available immediately when they need it. And so one of the great things about the [Alpha Informatics] platform, and the first feature set will be in neurophysiology, will be that we are able to tell surgeons, "Hey, if you're using a minimally invasive approach, you are heading toward a nerve root." We'll be able to tell a surgeon that in real time so that they can redirect their course and also keep incisions small enough to where they don't have to visually see it. Additionally, we'll be able to tell surgeons, "Hey, you're retracting this nerve," and there will be objective information that would suggest that there's been changes in the recordings of some of the monitoring to suggest that he's been retracting too long or too much. And so that type of information is what surgeons want so what they can do is make changes in real time in the operating room. And there's very few techniques in spine where nerve is not retracted. So the applicability really goes across many procedures.



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Brooks Gregory O'Neil - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

That's very helpful. So I just want to clarify, I have a sense that, in today's world, there's a technician sitting in an OR doing the neuromonitoring and in some way, communicating with a physician at a remote location, whereas with your system, it'll be real time, direct information to the doctor during the procedure. Is that right?

Patrick S. Miles - *Alphatec Holdings, Inc. - Executive Chairman & CEO*

Yes, that's right. But I think the beauty of the technology is that it really avails itself to -- if a surgeon has a neurophysiology partner that he feels strongly -- has a strong relationship with and a great deal of trust in, this piece of equipment can be used with a neurophysiologist or without a neurophysiologist. We want to make sure that the technology is available for all situations.

Brooks Gregory O'Neil - *Lake Street Capital Markets, LLC, Research Division - Senior Research Analyst*

That makes sense. That's very helpful. So if you could just help us understand where you are with the 12 Alpha launches as well. Are there -- are they all in the marketplace today? Are there some more coming in Q4? Just give us a sense for where you're at on that.

Patrick S. Miles - *Alphatec Holdings, Inc. - Executive Chairman & CEO*

Thanks. I'll tell you. Like we are running at them. And so one of the fun things is we have a next-generation thoracolumbar fixation system literally going out next week. And these are huge systems where there's thousands of parts involved in these Alpha launches. And so we'll have a MIS, an open fixation system go out next week. We have a number of the porous titanium implants in market now. OsseoScrew will release in Alpha form here in the next month. And we'll have a few more implants released before year-end. So I would tell you that we are sprinting at the end of the year, and this is what this group does best. And so I can't be more enthusiastic with regard to what we've assembled to date and clearly, what's forthcoming.

Operator

(Operator Instructions) Next question comes from the line of Scott Gambill from Gardner Financial.

Scott Gambill

Do you guys happen to hear a little bit of an echo out there?

Jeffrey G. Black - *Alphatec Holdings, Inc. - Executive VP & CFO*

We don't.

Scott Gambill

[I don't]? Okay. It's just my end then. All right. I'll get through it. I just had a question on the guidance for the year. It looks like you kind of pulled the low end -- you gave us a range now, and it's a -- \$92 million, \$95 million. Was part of that because of maybe some timing of these new product launches?

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Patrick S. Miles - Alphatec Holdings, Inc. - Executive Chairman & CEO

Yes, Scott, this is Pat. I would say that it's a little lumpiness in terms of -- we are making so many additions to the sales force. And the timing of when these guys get out has been a bit -- a little bit lumpy, and we've been -- the clarity in terms of exactly when they'd contribute. The other things are we're running at these Alphas and trying to get hospital approval and things of that nature. So if there's a little bit of a drag in some of the top line based upon just the hospital approval, we just want to make sure that we're being thoughtful.

Scott Gambill

Yes, okay. That makes total sense. I just wanted to see if I could get a little bit certain about my thoughts on that. The only other question I have right now is looking at the loss -- operating losses. I know they've climbed this year, and I know it's because of the build that you guys are doing internally. But I'm just wondering if you could maybe share your vision of how the company gradually works towards profitability and maybe when you might have a target for that.

Jeffrey G. Black - Alphatec Holdings, Inc. - Executive VP & CFO

Yes, Scott, this is Jeff. We're not -- we, at this point, are not going to provide any forward guidance on profitability. But I think the way to think about the business is that, for sure, we'll continue to invest in R&D with the intent of releasing 8 to 10 new products. But we will start to see scale in operating leverage once we start to scale the business. So we'll see sales expenses come down as a percentage over time. We'll certainly see scale in the G&A line. You'll see that we've actually taken a pretty hard line and tried to keep core G&A relatively flat. So I think the way to think about it is that continued investment in R&D with operating leverage as we scale the revenue line.

Scott Gambill

Okay. Would that scaling be something that I should anticipate next year?

Jeffrey G. Black - Alphatec Holdings, Inc. - Executive VP & CFO

Yes, I think you'll start seeing it. But I think, ultimately, it's really next year about making sure that we have the right investment in sales and marketing and product development and get these 12 new Alphas into commercial launch. So I think that when you really start seeing the benefit of scale is probably later in 2019 and 2020.

Operator

(Operator Instructions) I am showing no further questions at this time. I would now like to turn the conference back to Pat Miles.

Patrick S. Miles - Alphatec Holdings, Inc. - Executive Chairman & CEO

Thanks much, Rishi. Appreciate everybody who has participated on the call, and we look forward to a -- being in touch next quarter. Thanks much. Take care.

Operator

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



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