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COO - Q2 2013 The Cooper Companies, Inc. Earnings Conference Call

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OVERVIEW:

Co. reported 2Q13 GAAP EPS of $1.52 and non-GAAP EPS of $1.50. Expects FY13 total revenues to be $1.575-1.605b and GAAP EPS to be $6.42-6.52.

CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the second quarter 2013 The Cooper Companies earnings conference call. My name is Philip, and I'll be your operator for today. At this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session.

(Operator Instructions)

As a reminder, this conference is being recorded for replay purposes. I would you now like to turn the conference over to your host for today, Ms. Kim Duncan. Please proceed, ma'am.

Kim Duncan - *Cooper Companies Inc - Senior Director IR*

Good afternoon, and welcome to the Cooper Companies second quarter 2013 earnings conference call. I'm Kim Duncan, Senior Director of Investor Relations. Joining me on today's call are Bob Weiss, Chief Executive Officer, Greg Matz, Chief Financial Officer, and Al White, Chief Strategy Officer.

Before we get started, I'd like to remind you that this conference call contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995, including all revenue and earnings per share guidance and other statements regarding anticipated results of operations, market conditions, and integration of any acquisitions. Forward-looking statements depend on assumptions, data, or methods that may be incorrect or imprecise and are subject to risks and uncertainties.

Events that could cause our actual results and future actions of the company to differ materially from those described in the forward-looking statements are set forth under the caption Forward-Looking statements in today's earnings release. And, are described in our SEC filings including the business section of Cooper's annual report on Form 10-K. These are publicly available an on request from the Cooper Companies Investor Relations department.

Before I turn the call over to Bob, please let me comment on the agenda for the call. Bob will begin by providing highlights on the quarter, followed by Greg who will then discuss the second quarter financial results. We will keep the formal presentation to roughly 30 minutes and then open up the call for questions. We expect the call to last approximately one hour. We request anyone asking questions please limit yourself to one question.

Should you have any additional questions please call our investor line at 925-460-3663. Or e-mail IR at coopercos.com. As a reminder, this call is being Webcast and a copy of the earnings release is available through the Investor Relations section of the Cooper Companies website. With that, I'll turn the call over to Bob for his opening remarks.

Bob Weiss - *Cooper Companies Inc - CEO*

Thank you, Kim, and good afternoon everyone. A few second quarter financial highlights. Another solid quarter, I'm very pleased with the results. Top line growth of 11%, GAAP earnings per share of $1.52, up 36% versus the prior year. Non-GAAP earnings per share of $1.50 is up $0.38, or 34%. And, financial, or free cash flow, was $77.4 million, which means our trailing 12 month free cash flow is $243 million.

Some highlights and key events. Our silicone hydrogel family of soft contact lenses continues to show strong growth. And, our recently announced launch of MyDay, our branded single use silicone hydrogel lens, should continue our momentum for many years to come. We recently announced our planned exit from Aime, our non-core lens and lens care business in Japan.

Aime came with our purchase of worldwide supply control of raw materials for silicone hydrogel family of products and the selling rights for Biofinity in Japan. Biofinity has been a stellar success in Japan, up 2.5 times above the prior year's second quarter in constant currency. Overall our silicone hydrogel family worldwide is up 31% in constant currency and accounts for 43% of CooperVision's revenue.

For the most recent calendar quarter, we grew 3 times the market growth of 4%. Our gross margin percent for the quarter achieved over 66%, deriving an operating income margin of 21%. Strong free cash flow during the quarter allowed us to de-lever our debt to total cap to only 12%.

On sales results, our second quarter -- during the second quarter our silicone hydrogel family continued to drive our top line and our bottom line results. Silicone hydrogel revenues were $134 million. The halo effect of Biofinity Toric in Japan continues. In Japan, Biofinity constant currency sales are up over 2.5 times the prior year second quarter.

The relaunch of Avaira Toric is also continuing its halo effect on Avaira, two week family of products where during the second quarter we were -- they were up over 50% versus the prior year in constant currency. Following our successful private label roll-out of single use silicone, we have now recently announced our launch of MyDay, our branded single use silicone hydrogel lens. We expect this newest addition to our silicone hydrogel family of soft contact lenses to help continue our silicone hydrogel revenue growth momentum for many years to come.

Geographically, foreign exchange headwinds continue, reducing our CooperVision revenues by 4% in the quarter. Excluding foreign exchange, CooperVision constant currency growth was 11%. Last year was the Euro and this year it's the Yen, which, at recent exchange rates, is down almost 30% from the high of JPY77 per $1.00. With over $200 million of revenue in Japan, this is not only impacting our revenue, but also negatively impacting our gross margin percent as well as our operating income margins.

But, even with this nuisance on our -- on the strength of our product lines, we are putting up solid numbers. From a revenue perspective, regionally we have put up solid constant currency growth in all locations. Americas, up 12%, Europe, up 8% constant currency, and Asia-Pacific up 13%. And, overall, as I mentioned, 11%.

Our growth drivers are in the Americas, trading up to the Biofinity -- trading up to Biofinity including the halo effect of Biofinity Multi-focal, with the entire family doing well. Also, while off of a much smaller base, Proclear 1 Day and the Avaira Toric and family are significant contributors. In Europe, right now currency isn't a big factor. During our 8% -- driving our 8% constant currency growth in this region is the entire Biofinity family and 1 Days including single use silicone.

In Asia-Pac, while foreign exchange took its toll in revenues, our constant currency revenue was up 13%. Drivers, the tremendous success of Biofinity family in Japan with a halo effect of Biofinity Toric as well as Proclear 1 Day and single use Torics. The worldwide soft contact lens market in the first quarter of 2013 was up 4% in constant currency, while CooperVision was up 12% during the same time period.

For the trailing 12 months ended March 31, the soft contact lens market, now $7.2 billion worldwide, was up 4% in constant currency. CooperVision was up 11% on the strength of Biofinity, Proclear 1 Day, and Avaira. For the calendar quarter, the market growth was sponsored by 1 Day. While CLI, or contact lens, has stopped reporting the growth of silicone hydrogel material, most likely this trade-up material remains solid growth material.

CooperVision was up 31% in constant currency in the fiscal second quarter of 2013, and at CooperVision silicone hydrogel now represents 43% of our revenues. The soft contact lens market continues to be a trade-up market. This includes two premium products, silicone hydrogel lenses, Torics, and multi-focals. A trade-up to one day disposables expands patient revenue by 400% to 600%. Even more important, the one day wearer generates 300% to 500% more profit.

Also, it's important to understand that Toric and multi-focal have long -- have a long way to go in capturing the market opportunity, especially outside the United States. Geographically, the strength of the Americas plus 6% and trading up to 1 Days has been driving the market. Overall, the market was up 4% for the quarter and trailing 12 months. Our expectations remain for the market to grow 4% to 6% continuing, and CooperVision continuing to gain market share.

Cooper Surgical, our worldwide franchise turned -- our women's healthcare franchise turned in $75 million in revenue, up 32% versus the prior year's second quarter, on the strength of a $20 million revenue contribution from Origio, our IVF acquisition of a year ago. We are pleased with our IVF integration activities. Our IVF, or global fertility products, were up over 10% organically versus the prior year period.

Overall, the medical device market, including OB/GYN offices, are in transition with considerable consolidation of office practices. And, in the United States, a new medical device tax. During the quarter, Cooper Surgical on an organic constant currency basis was essentially flat.

Even so, we believe we continue to gain share. Longer term, we expect to continue to leverage our Cooper Surgical infrastructure, or critical mass, expanding outside the United States by growing IVF and channeling new products through this franchise. Within our women's healthcare franchise, products such as IVF products for fertility presents the greatest opportunity for a truly global reach.

Couple comments on guidance. We updated our guidance in late December, following the amendment of our CIBA/Alcon royalty agreement, and again when we released our first quarter earnings results. Given the strength of our second quarter results on the bottom line, we brought about -- it brought about a strong gross margin trend and favorable effective tax rate, we have again upped our new GAAP earnings per share guidance in spite of a worsening trend on foreign exchange rates, or more specifically the Yen, which is down 8% since our March earnings call.

While constant currency revenue is doing great, we have moderated our revenue guidance to reflect Yen weakening, given we have over $200 million in revenue, or about 17% of our sales, at CooperVision that are Yen-based. Our new guidance on non-GAAP earnings per share this year of $6.15 to $6.25 versus previous guidance of $5.95 to $6.10 reflects the strength and progress of our product portfolio including Biofinity, acceleration of market share gains, favorable second quarter results, and the lower effective tax rate for this fiscal year.

In spite of increasing our bottom line results and guidance, we continue to invest geographic expansion and R&D with emphasis on D, or product development. This D is what has accelerated our roll-out of new products like MyDay, our new branded 1 Day silicone hydrogel lens. On strategy, we are continuing with our successful strategy, which I frequently have articulated in the past, we believe it is solid and has delivered results.

Cooper Surgical is putting up solid results and is leveraging its infrastructure. The franchise was built with a solid understanding of the value of critical mass in the women's healthcare market, targeting OB/GYNs. We follow the profession wherever they go, office, surgery center, hospital, or IVF centers. Although, the call points are different for each, the leverage is considerable.

Cooper Surgical's second quarter '13 gross profit was 65%, operating margins were 17%. And, due to minimal capital requirements, Cooper Surgical is a significant contributor to free cash flow. We are dedicated to this strategy and will continue tuck-in and non-US acquisitions to leverage the Cooper Surgical structure and products.

At CooperVision, the strategy is more complex and is much more global in nature. In the $7.2 billion soft contact lens industry, because of the uniqueness of our manufacturing platform and product portfolio, we are the only participants that could aggressively promote silicone and non-silicone hydrogel lenses, that is the Proclear family, emphasize branded and non-branded products, note private label does not mean lowering our operating margins.

We actively promote and specialize in custom lenses with a high gross profit, of course. We support all modalities that eye care physicians prescribe, 1 day, 2 week, and monthly modalities. And, we support all types of lenses, Sears, Torics, and multi-focals. We're close to 30% share in the high growth specialty categories, Torics and multi-focals, and is acknowledged by eye care professionals that we're pretty good at specialty contact lenses.

Few eye care professionals would challenge why the success of Biofinity Toric for astigmatism. Put a great design together with a great material and great things can happen. We have seen similar successes for the same reason with Biofinity multi-focal which shipped the market in the middle of 2011.

On the capacity front, with the exception of Avaira Toric, we are ahead of plan to deliver considerably more product where we had been previously supply constrained. The Biofinity family, Proclear 1 Day, are all in good capacity shape. Our newest challenge will be to ramp up 1 day silicone hydrogels, as yet a niche market. On pricing, we, like the rest of the soft contact lens industry, have a trade-up strategy. Our new wearers and existing wearers are targeted for silicone hydrogel lenses.

The Proclear family and the 1 day, or single use lenses, each creates more revenue per patient. A 1 day modality, for example, results in 4 to 6 times more revenue you per wearer. While this strategy sacrifices the gross profit margin, or percent, it generally creates 3 to 5 times more profit per wearer.

Of course, this strategy competes head-on with the lens care space, since we are shifting the wearer resources from lens care to contact lenses only. Competing for lens care dollars is more a problem for some of our competitors. In my opinion, we continue to be the most focused company in the industry, lacking many of the distractions that some of our competitors are now going through. I might add with Biofinity, Avaira, and Proclear, we have a lot to talk about with the eye care professionals all around the globe.

As we look down the road over the next several years, we expect to continue improving operating margins and delivering above average shareholder returns. We expect to continue to average double-digit earnings per share growth while investing in geographic expansion and new product development. In today's market, we are a solid product -- we have a solid product portfolio to leverage in all modalities.

Multiple materials, all lens types, and we retain our expertise to emphasize customizing the lenses for the 10% to 20% of those lens wearers requiring other than standard lens sizes and/or designs. We have a lot of work to do before we come anywhere close to having exploited our number one contact lens family, Biofinity. This is particularly true when it comes to geographic expansion and fully developing the lens family of Torics and multi-focals around the globe.

The same applies to Avaira, where the Avaira Sphere has been anxiously awaiting the relaunch of Avaira Toric. The combination has put us in a much better position to exploit the US two week space owned by Johnson & Johnson. And, to also exploit our private label strategy more aggressively with this family.

While we already have pretty respectable gross profit and operating margins from a cost perspective, we have considerable upside yet to be fully developed. Upsides include the complete elimination of silicone hydrogel royalty, the expiration of patents in September 2014 in the United States and March 2016 in the rest of the world. The reduction of our manufacturing costs by, among other things, improving moldings, cycle times, increasing capacity, utilization, and improving yields in general, each of these are key goals for us.

Also, given the considerable amount of free cash flow we generate, we will continue to look for tuck in acquisitions and geographic expansion opportunities, like Origio, in our two businesses. The key requirements, however, is that each must exceed our minimal investment hurdle rates. Each must achieve, over time, a hurdle rate that exceeds 10% return on invested capital.

Additionally, the markets for both women's healthcare and soft contact lenses are much less developed outside the United States and we generate a considerable amount of cash flow offshore due in part to our level manufacturing outside the United States. As such, we will continue to aggressively invest in global expansion opportunities. With over 95% of the people on the planet outside the United States we believe we will find opportunities to invest in other countries for decades to come, thereby sustaining our low effective tax rate indefinitely.

And, finally, we again this year demonstrated we are opportunistically willing to buy some of our own stock to maximize total shareholder return. In summary, before I turn it over to Greg, let me say how pleased I am with our ongoing progress. We continue to outperform the marketplace, most recently growing 2 to 3 times the market rate of growth.

Our top line growth in a skittish global economy remains solid. And, I am very pleased at our double-digit organic constant currency growth at CooperVision during the quarter and year-to-date. Our family of products, Biofinity, Avaira, Proclear 1 Day, and now 1 Day single use silicone, as well as in women's healthcare, our global fertility products, are all promising growth going forward.

We continue to execute well and invest in geographic expansion and the new product pipeline. While we are still early with our expansion program in each of the BRIC countries, and there are challenges in each, I am very pleased with our progress to date. Our women's healthcare franchise has now become more global with the Origio acquisition made one year ago.

We remain keenly focused on delivering consistently improving results, mindful of our desire to invest and leverage prudently, thereby delivering a respectable total shareholder return. And, lastly, as always, a reminder that at Cooper our number one asset is our employees. To them, a big thank you for consistently delivering great results. And now, here's Greg.

Greg Matz - *Cooper Companies Inc - CFO*

Thanks, Bob, and good afternoon everyone. Bob shared with you a pretty thorough review of the market and our revenue picture. Let me start with gross margins. Looking at gross margins in Q2, consolidated GAAP and non-GAAP gross margins were 66.2%, compared with 64% for GAAP and non-GAAP in Q2 last year.

We continue to see strong headwinds due to the impact of foreign exchange, predominantly the Yen, on our revenue and the related direct impact on gross margins which had just over 100 basis point impact on the quarter. In addition, Avaira's successfully re-launching, and as we've discussed in prior quarters, Avaira does have a lower than company average gross margin. Also, our new single use silicone lens creates some margin pressure as we start to bring it to market.

Finally, we also continue to see a mix impact due to Origio, of which we acquired in July 2012. Despite these headwinds, we continue to run favorable margins well above 60%, due to a reduced CIBA royalty, strong product mix led by Biofinity, and increased manufacturing efficiencies.

CooperVision, on a GAAP and a non-GAAP, basis reported a gross margin of 66.6%, versus 63.3% for GAAP and non-GAAP in Q2 last year. As I just mentioned, CooperVision's gross margin was negatively impacted by FX, largely the weakening of the Yen. As well as, on a much smaller scale, the success of Avaira as it relaunches into the market.

We continue to be excited about Avaira as it opens up the two week silicone market, especially in the US, which we were not addressing effectively last year at this time. As Bob mentioned, the Avaira family continued to grow above 50% year-over-year. Factors driving the year-over-year gross margin improvement were the reduction of our royalty expense, product mix, and manufacturing efficiencies.

Cooper Surgical had a gross margin of 64.5%, which compares to Q2 '12 of 68%. Excluding Origio, gross margin would have been 66.7%. Cooper Surgical continues to experience the same industry headwinds of lower office visits and fewer procedures being done that other medical device companies have recently reported.

Now, looking at operating expenses. SG&A in the quarter, SG&A expenses increased by 10% from Q2 last year to $150.7 million and were 39% of revenue versus 40% of revenue in the prior year. Majority of this growth was Origio since we had no Origio SG&A in the prior year. We had about $700,000 of medical device excise tax in the quarter that hit SG&A. We expect about $2.6 million in 2013. SG&A was basically flat sequentially.

Now, looking at R&D. In Q2 R&D increased by approximately 11% year-over-year to $14.5 million, or up about $1.5 million. Excluding Origio, R&D would have increased approximately 3%. R&D was 3.8% of revenue, comparable to Q2 '12, and up from 3.6% sequentially. As we discussed in the prior quarter, we would expect that R&D will continue to grow slightly faster than sales during the fiscal year.

Depreciation and amortization, in Q2 depreciation was $23.4 million, up $1.9 million or 9% year-over-year. And, amortization was $7.5 million, up $2.2 million, or 43% year-over-year, for a total of $30.9 million. Origio amortization for the quarter was approximately $2 million.

Moving to operating margins. For Q2, consolidated GAAP and non-GAAP operating income and margin were $81.5 million, or 21.2% of revenue, versus $65.4 million or 19% of revenue in Q2 '12. This represents 24.5% increase in operating income over Q2 '12. The increase in operating margin is primarily due to the overall gross margin improvement I mentioned earlier.

Interest expense, interest expense was $2.4 million for the quarter, down 20% year-over-year. Looking at the effective tax rate, in Q2 the GAAP and non-GAAP effective tax rate was 4.4% and 5.5% respectively versus Q2 '12 GAAP and non-GAAP effective tax rate of 12.4%. As we've discussed before, the effective tax rate continues to be below the US statutory rate as the majority of our income is earned in foreign jurisdictions with lower tax rates.

In Q2 the single biggest factor impacting our effective tax rate was the favorable settlement of a multi-year foreign tax authority audit which reduced the quarterly rates by about 400 basis points. So, our 5.5% non-GAAP rate would have been 9.5% without this. We now expect the full year GAAP effective tax rate to be in the range of 6% to 8% and the non-GAAP effective tax rate to be in the range of 7% to 9%.

When thinking about these ranges, our future effective tax rate, remember there were some nonrecurring items so far this year including the settlement I just mentioned and the multiple years of R&D tax credit which was renewed in Q1. These will amount to roughly 150 basis points improvement in the effective tax rate this year. The other driver in the lower effective tax rate is the reduction of the CIBA royalty which increased offshore profits, which we will continue to see going forward.

Turning to earnings per share. Our Q2 earnings per share on a GAAP and non-GAAP basis was $1.52 and $1.50 respectively versus $1.12 on a GAAP and non-GAAP basis in Q2 '12. EPS is up 36% and 34% on a GAAP and non-GAAP basis respectively versus the prior year. On share repurchases, there was no share repurchase activity in Q2.

Turning to FX. While currencies continue to be volatile, the primary impact to us, as Bob had mentioned, has been the Yen movement. We have seen the Yen decrease 18% year-over-year and over 5% from our Q1 earnings call. Of on a year-over-year basis we absorbed a negative FX impact in Q2 of $0.18.

As we look at the remainder of the year, we continue to see headwinds with the Yen. Assuming today's rates we see an additional $5.5 million negative impact on revenues from the last earnings call. Although we have operating expense offsets from our overseas operations, and eventually offsets in cost of goods sold for pound based inventory, to a much lesser extent Yen based raw material purchases, we estimate this negative revenue impact will amount to approximately $0.07 impact on EPS for the second half.

Just FYI, the FX rates we're using, because the Yen has been all over the place just today alone, is the Euro at $1.32, and the Yen at JPY98. Balance sheet and liquidity items, in Q2 we had cash provided by operations of $114.9 million. Capital expenditures of $38.2 million. And, an insurance recovery of $700,000 resulting in $77.4 million of free cash flow which included approximately $11 million from the payment for business interruption insurance.

Total debt decreased within the quarter by $87.5 million to $320.5 million. Debt, as a percent of total capitalization, is now 12%. Inventories increased by $13.9 million to $339.3 million from last quarter. For the quarter we are seeing months on hand at 7.8 months. Up from a months on hand of 6.9 months last year and up from 7 months last quarter.

The increase is primarily due to the increase of inventory for silicone and daily products as well as the reduction of the CIBA royalty which reduces costs of goods sold and has the effect of raising months on hand. Account receivable continues to be well managed with DSOs of 54 days, up slightly from 53 days lat year, but down from 58 days at the end of last quarter.

Now, turning to guidance. As Bob mentioned, we revised fiscal 2013 guidance. Total company revenue is now expected to be in the range of $1.575 billion to $1.605 billion, for a year-over-year growth of 9% to 11%. We expect CooperVision revenue in the range of $1.26 billion to $1.28 billion, for a year-over-year growth of 6% to 8%. This equates to a constant currency growth of 9% to 11%.

For the second half, we would expect CooperVision to grow 7% to 10% on a constant currency basis. We expect Cooper Surgical revenue in the range of $315 million to $325 million, with a year-over-year growth of 23% to 27%. We expect non-GAAP gross margin to be in the range of 65% to 65.5%. And, non-GAAP operating margin to be in the range of 21% to 22%. We expect interest expense of $9.5 million to $10.5 million. And, as previously mentioned, non-GAAP effective tax rate of 7% to 9%.

Our GAAP earnings per share is estimated in the range of $6.42 to $6.52 and excludes the impact of the potential Aime transaction. Our non-GAAP earnings per share is estimated in the range of $6.15 to $6.25. This being based on a diluted share count of 49.6 million shares. Finally, we expect capital expenditures for the year of $200 million to $250 million and free cash flow of $170 million to $200 million. With that, let me turn it back to Kim for the Q&A session.

Kim Duncan - *Cooper Companies Inc - Senior Director IR*

Operator, we're ready to take some questions.

QUESTIONS AND ANSWERS

Operator

All right. Ladies and gentlemen, if you have a question, please limit yourself to one question.

(Operator Instructions)

Kim Gailun, JPMorgan.

Kim Gailun - *JPMorgan - Analyst*

Okay, guys, thanks for taking the questions. Nice quarter here. I guess -- the first question maybe just on Biofinity, you had another really solid quarter and you're at a place now where silicone hydrogel, as a percentage of CooperVision sales, is pretty close to on par with where we think the industry is.

I've also thought that Cooper, because you're underindexed in dailies should actually be able to go higher than the industry, but I think it would be helpful just to walk through what you see as the runway for Biofinity from here. And, maybe Avaira, so silicone hydrogel as a family, and then as you bring in the daily.

Bob Weiss - *Cooper Companies Inc - CEO*

Okay, Kim. As far as we're concerned, Biofinity, which is approaching a $500 million run rate product line with solid double-digit growth, still has a lot of runway left. And, as I mentioned in my comments, a lot of that runway still has to do with Japan and the rest of the world where this product obviously is viewed in a very special league within silicone hydrogel lenses.

And, I think there is no reason to think that it won't continue to perform very well, albeit off of a much higher base going forward in the monthly -- particularly in the monthly modality. Avaira, of course, is just really getting going. It took a couple years to get Avaira Toric aligned so we can see the halo effect of Avaira Toric with the Avaira Sphere line. I mentioned that it you grew as a family off of a, granted, a much smaller base, more than 50% on a year-over-year basis.

So, we're pleased with the momentum it's starting to develop. So, I look at it at each -- how are they going to do in each modality. We have good entree in monthly with Biofinity, and that will continue to do well. Probably the non-growth factor globally, or the one that will grow the least, is the 2 week modality, but it is a huge opportunity where we're underindexed. And then, of course, the real growth right now, from the point of view of the overall lens industry, is the 1 Day modality, sponsored partly by the US where it's doing extremely well.

In that area revenue has gone, in the industry, from 11% three years ago to well over 20% now. We think between Proclear 1 Day, and now MyDay, we have good entrees in that area. So, when I think about it, I think of the way we present the CLI data in the back of our release. We're gaining share on all fronts right now.

I don't care if you look at modality. I don't care if you look at geographic areas. And, I don't care if you look at types of lenses, which unfortunately we weren't able to present this go-round because the Contact Lens Institute has suppressed some data which doesn't allow us to be able to tell you what the industry did.

But, ourself, we did very well, as you can see. Can't really tell you how. But, we think we're covering all fronts pretty effectively. And, we'll gain share pretty effectively. And, that translates to expecting good growth out of Biofinity in the monthly Avaira in the 2 week and Proclear 1 Day and MyDay in the 1 Day.

Kim Gailun - *JPMorgan - Analyst*

Okay, great. Thank you.

Kim Duncan - *Cooper Companies Inc - Senior Director IR*

Next question.

Operator

Jeff Johnson, Robert Baird.

Jeff Johnson - *Robert W. Baird & Company, Inc. - Analyst*

Thank you. Good evening, guys. Bob, was wondering if I can start with a couple margin questions, I guess. First, on MyDay, from your press release on MyDay today, it sounds like it's going to have a lower silicone content, sounds like the DK's going to be 80 on that lens.

Wondering what that means from your ability to reduce the alcohol content? How that might help margins scale a little faster in that product, if you can get some of the alcohol out quicker? And, just maybe an update on what gross margin for that product is? Has been doing here over the last few months since you last updated?

Bob Weiss - *Cooper Companies Inc - CEO*

Well, you're right in your focus on that and gross margins. MyDay initially, like many of our new launch products, will have marginal profits. We have moved into a profit mode but we have a long way to go. We have, as a matter of now being seven or eight years into silicone hydrogel production, gotten better and better with even products that include the alcohol in the manufacturing process.

While that's not an end point in the sense of we expect some day to have alcohol -- potentially alcohol removed from certain silicone hydrogel products, that may be different families of products. But, for now, these products, Biofinity, Avaira, and MyDay do use alcohol in production and will likely do so in the future, for at least indefinite future.

As far as expectation, we were able to move the needle real far with Biofinity since we did a start-up. And, when we started up Biofinity it in fact had zero gross margins. Today, it has gross margins well in excess of the top end of our -- let's say well into the 70%s and that obviously plays well from the point of view of our gross margin mix given it's growing off of a high base.

1 day has a long way to go in terms of weighting, being it's significant weighting factor. And, in our case, the start-up process with lead time on equipment is fairly extensive, 12 to 18 months, and that's not only us but our competitors that are ramping up over the next several years. So, by the time we get to where it's meaningful, we would expect to have improved gross margins for MyDay, similar to what we've done with our other 1 Day which is Proclear -- Proclear 1 Day.

Jeff Johnson - *Robert W. Baird & Company, Inc. - Analyst*

Okay. If I can just ask a quick follow-up on the margin front. Greg, I guess for you, CVI gross margin, it sounds like if I ex out the currency, the Yen weakness and what have you, gross margins for CVI would have been up 400 to 500 basis points this quarter, year-over-year.

Obviously, the lower royalty has the biggest contribution, or a big contribution there, I'd assume. But, even back of the envelope, I know you won't tell us what the royalty came down to, but back of the envelope it seems like to me that was maybe 150, 200 basis points. Where that other 200 to 300 basis points of gross margin improvement coming on a constant currency basis for CVI?

Bob Weiss - *Cooper Companies Inc - CEO*

Let me jump on part of that. With Biofinity being the magnitude of product it is in our portfolio, and with it having the very attractive gross margins that I mentioned, with or without the royalty, no matter how you view that calculation, it is a driver of our gross margins. Number one, it's a multi-modality so it's easier to have high gross margins in the monthly modality. It's good to have a product of that caliber that I mentioned is annualizing close to $500 million a year.

So, by far, it is driving a lot of what we're seeing in CooperVision in terms of gross margins. Incrementally, when you look across all the other lines, and even considering mix, we are lowering cost on pretty much all fronts, whether it's the 1 Day modality, the 2 week modality, or the monthly modality, costs are coming down in parallel with that balancing mix, if you will, of products. Greg, by all means add.

Greg Matz - *Cooper Companies Inc - CFO*

I think, Bob, that's a good summary. Jeff, you obviously know our sensitivity of protecting the confidentiality of the agreement that we have. I think I covered the key factors that are really driving it. One is strong product mix, as Bob said, led by Biofinity.

Manufacturing efficiencies, as you know, Fernando is our manufacturing Vice President who handles all our operations, just has done a fabulous job over the last five years of improving, his team improving the efficiency in the factory. And, that's helped drive up margins. And, obviously, then the other big piece is the royalty which we can't really go into more detail on.

Jeff Johnson - *Robert W. Baird & Company, Inc. - Analyst*

All right. Thanks, guys.

Operator

Chris Cooley, Stephens.

Chris Cooley - *Stephens Inc. - Analyst*

Yes, thanks for taking the question. Bob, I was just wondering if you could talk to us a little about how you see the single use silicone market evolving going forward. In particular with the company's decision to go with a lower content, or I should say lower DK version, versus many of the competitive offerings. How do you see the US market shaping up for that over time? Thank you.

Bob Weiss - *Cooper Companies Inc - CEO*

Well, I think that I've frequently said that the market today is a niche market. It's probably in the neighborhood of $300 million, $300 million to $350 million, maybe as high as $400 million, but certainly not above that worldwide. With the dominant portion of that coming out of Japan where J&J has TruEye. In the US, it's been hitting its head somewhat on the ceiling of the type of wearers because of the current price points of 1 Day silicone hydrogel lenses.

As long as the price points are where they are, there is some limitation in many of the markets around the world, so that's a factor. Having said that, you have all the three majors, if you will, spending a lot of energy developing that market. Why? Because number one, trading into a 1 Day is worth 400% to 600% more revenue per patient. The US is ripe for that.

And so, there's a want to solve the 1 Day riddle in the US. And, concurrently, while you're migrating people into the 1 Day modality, give them the option of a silicone hydrogel since so much of the market today, I'd say it's about 50% and 50% now, almost 50% the market in revenue dollars is silicone hydrogel, 50% is non -- is hydrogel. We've got a market split and there is a lot of eye care professionals that want a silicone hydrogel 1 Day option and they'll try to move the mark with that.

We're going to be there. We're going to be a meaningful player there. And, I think with the energy of the industry, the three majors in that area, they'll move the needle. And, this will not be a niche product three years, four years, five years down the road.

Chris Cooley - *Stephens Inc. - Analyst*

Thank you.

Operator

Larry Biegelsen, Wells Fargo.

Larry Biegelsen - *Wells Fargo Securities, LLC - Analyst*

Good afternoon, thanks for taking the question. So, on guidance, can you help tease out the reduction by $10 million for CooperVision and for Cooper Surgical, how much of that was FX, how much of that was operational? And, on the gross margin, I heard the guidance for the full year. But, can you talk a bit about what you expect for the third and fourth quarter from here, 66.2%, I think in the second quarter.

I guess my question is, do you think it will improve sequentially from here throughout the year? And lastly, Bob, did you see the same effect this quarter as you saw last year where April was soft but May bounced back? Thanks.

Bob Weiss - *Cooper Companies Inc - CEO*

All right. The first one, and I'll let Greg amplify anything I miss. On the reduction on the top end of the range by $10 million, the majority clearly for vision was FX. For surgical, there is, as depicted by the second quarter results, some softness being experienced.

I think that's consistent with what we've seen in the industry, be it all the competitors in the space have commented on the softness on the office side of equipment and instruments right now. So, there's some of that built -- we experience of the second quarter rolling into the full year results on the surgical side.

As far as gross margins where they are, do we expect sequential where it's going to go directionally, generally ballpark the same. So, that would wade out to the guidance that Greg gave you. As far as the last year event, which you're absolutely correct, was a very weak last week, last two weeks of April, and a lot of that slipping into May, we didn't see that phenomenon develop this year.

It's a more normalized cycle, if you will, with May starting out, which is built into our guidance, by not having any windfall compared to the prior year, which was a flip-flop between the second -- the second two weeks -- the last two weeks of April flipping somewhat into May.

Larry Biegelsen - *Wells Fargo Securities, LLC - Analyst*

Thank you.

Bob Weiss - *Cooper Companies Inc - CEO*

Greg, I don't know if there was anything you wanted to add to that.

Greg Matz - *Cooper Companies Inc - CFO*

No, Bob, I think you hit it.

Operator

Joanne Wuensch, BMO Capital Markets.

Joanne Wuensch - *BMO Capital Markets - Analyst*

Thank you very much for taking my questions. First, some clarification. Does your lower revenue include or exclude Aime at this stage?

Bob Weiss - *Cooper Companies Inc - CEO*

Great question. The answer is Aime is built into those revenue numbers.

Joanne Wuensch - *BMO Capital Markets - Analyst*

Built in meaning you've pulled it out or it's still included?

Bob Weiss - *Cooper Companies Inc - CEO*

Oh, no, it's included. It's included.

Joanne Wuensch - *BMO Capital Markets - Analyst*

Okay. I thought you were selling portions of it and therefore we should be taking that out? No?

Bob Weiss - *Cooper Companies Inc - CEO*

I'll let Greg talk to the technical accounting discussion in that area.

Greg Matz - *Cooper Companies Inc - CFO*

I think right now our intent is to sell it. We have been -- we have somebody that we've signed an agreement with. There's still some closing conditions that are still to be achieved. And, once we have cleared those closing conditions, at that point we would treat that -- we would treat it as a sale on the accounting side. So, at this point, because those closing conditions are still open, we have not -- we're still treating it as usual going forward.

Joanne Wuensch - *BMO Capital Markets - Analyst*

Okay. My second question is could you please comment on the price point for the MyDay lens and remind us is this a sphere lens coming out and then when we should expect a Toric. Thank you.

Bob Weiss - *Cooper Companies Inc - CEO*

It is a -- from a price point of view, we're really not going to get into that. Particularly there's going to be a want for an element of surprise, if you will, on what we're ultimately going to do there in the US market. It is not shortly, near term, going to be in the US market. That's more 2014, sometime, calendar year.

As far as when we expect a Toric in that space, I think given the manufacturing constraints that the industry will have in many of the areas, anyway, it's a ways down the road, nothing imminent. It's initially going to be a sphere for at least the next several years. Next question.

Operator

Matthew O'Brien, William Blair.

Matthew O'Brien - *William Blair & Company - Analyst*

Good afternoon, thanks for taking the question. Was hoping to just tease out gross margin a little bit more. I know you guys don't want to talk about the royalty, but can you just give us a sense for -- you still have some headwinds out there on Avaira. When do you anticipate that headwind will dissipate somewhat? Aime, can you just quantify what the benefit of selling that business will do to the gross margin line?

Bob, you made a bunch of comments on manufacturing going forward, and some areas that you think you can benefit as well, just what do you think the opportunity is with those programs? And then, Greg, just to clarify on the tax rate side, I think historically you've been around 10% of an effective tax rate. Are you saying that with the royalty lessening that you think that tax rate may decrease something around 100 basis points going forward or how should we frame that? Thank you.

Bob Weiss - *Cooper Companies Inc - CEO*

All right. That was a lot. On Avaira going forward, we continue to improve the platform we are manufacturing on. I might say there's somewhat a game of musical equipment going on right now in the Avaira family and in the MyDay family, if you will.

All of which is pointed in a direction that will improve the end point together with the equipment that is on order that, let's say, similar to Biofinity where we had the first generation of equipment that in the case of Biofinity was put in the museum the first two pieces of equipment. We're not going to be there with Avaira. But, I would say we clearly know there are improvements we can make to modification to future equipment we're buying that will reduce cost of goods.

So, both on the Avaira front as well as on the MyDay front, that platform is similar, if you will. In terms of Aime, I would -- I'll defer to Greg on the implications of gross margins will improve without it. I don't know if you have any specifics.

Greg Matz - *Cooper Companies Inc - CFO*

No, it's pretty small. They will improve because it was definitely below our average gross margin. But, again, Aime is a relatively small piece of our overall business. You'll see an uptick. I don't know that it will be all that notable.

Bob Weiss - *Cooper Companies Inc - CEO*

As far as manufacturing going forward, I mentioned among other things cycle times. I mentioned in the past that we do have a desire to get alcohol out of a lot of the production in the area of silicone hydrogel lenses. That is a -- when I talk about R&D, that clearly is D work that we continue to work on. In terms of getting alcohol either diminished and/or removed in certain silicone hydrogel products in the future. In the area of other cost reductions over time, we did announce, that I mentioned last quarter, that we are expanding our third site into Costa Rica.

Costa Rica is an area where the platform there would allow for lower cost manufacturing. So, certain products would be more conducive to lower labor rates, if you will. Right now we're in locations that are far from our lower labor rates compared to global perspective. So, factors like that as we grow our business will come into play. That will help future gross margin trends. Effective -- let's say, comment on taxes, Greg.

Greg Matz - *Cooper Companies Inc - CFO*

Matt, we're a little early for guidance. I think it's a fair question. We look at the guidance we gave for the rest of this year we said 7% to 9%, in that range. Also mentioned there's probably 150 basis points, or a little more, of what I consider non-recurrent expenses.

So, we obviously don't expect to run next year at the 7% to 9% range. The guidance will be higher than that. If you take that 150 plus basis points and add it to our guidance range, it probably gets you -- it gets you in the right direction. Again, we'll determine guidance as we get farther into the year.

The other big thing we didn't mention real specifically, it really does have an impact on your geographic distribution of income. That changes or revolves over time. When we go to do guidance for next year that will be the thing that we'll be looking at to help. That also will impact the rate for next year.

Matthew O'Brien - *William Blair & Company - Analyst*

Thank you.

Bob Weiss - *Cooper Companies Inc - CEO*

Next question.

Operator

Steve Willoughby, Cleveland Research.

Steve Willoughby - *Cleveland Research Company - Analyst*

Hi, guys, how you doing?

Bob Weiss - *Cooper Companies Inc - CEO*

Pretty good.

Steve Willoughby - *Cleveland Research Company - Analyst*

Good. A question on the impact from currency. Greg, I think you said for the back half of the year you're thinking currency's going to negatively impact EPS by an incremental $0.07. For the second quarter that you just reported, how much of a negative impact was it relative to what you guys were thinking three months ago?

Greg Matz - *Cooper Companies Inc - CFO*

Three months ago it was about $0.035.

Steve Willoughby - *Cleveland Research Company - Analyst*

So, about a $0.10 headwind all together then for the year? Is that right?

Greg Matz - *Cooper Companies Inc - CFO*

Say it again, Steve. I missed that.

Steve Willoughby - *Cleveland Research Company - Analyst*

You're now expecting an incremental $0.07 from FX?

Greg Matz - *Cooper Companies Inc - CFO*

From the last guidance, yes.

Steve Willoughby - *Cleveland Research Company - Analyst*

Right. So, I guess how much of a negative impact was there from FX just on the second quarter relative to your guidance three months ago?

Bob Weiss - *Cooper Companies Inc - CEO*

Since March 8, that would be right the --.

Greg Matz - *Cooper Companies Inc - CFO*

$0.035.

Bob Weiss - *Cooper Companies Inc - CEO*

Plus the $0.07. $0.105.

Steve Willoughby - *Cleveland Research Company - Analyst*

Okay, got you. My second question was you were able to hold your SG&A dollars relatively flat despite an increase in revenue. How likely are you guys going to be able to do that over the rest of the year?

Bob Weiss - *Cooper Companies Inc - CEO*

I think to some degree foreign exchange, just like it hit our top line, certainly hits operating costs and minimizes operating costs somewhat. We are continuing in our venture of geographic expansion, so that's an up-push. Suffice it to say that I think in the guidance we're giving 21% to 22% [ally] that we're expecting improving -- some improving ratios the back six.

Greg Matz - *Cooper Companies Inc - CFO*

And, also, remember too we purchased Origio in July last year. Once you start hitting July you'll have a more even apples-to-apples comparison year-over-year.

Steve Willoughby - *Cleveland Research Company - Analyst*

Okay. Thanks, very much.

Operator

Larry Kush, Raymond James.

Larry Kush - *Raymond James - Analyst*

Hi, good afternoon. I guess two questions for Greg. First, on the free cash flow, obviously you maintained the guidance of $170 million, $200 million, yet you brought up your EPS guidance.

If you could just help me understand why that guidance is staying the same? And then, the second question is you indicated that you did not buy back any stock in the quarter. So, if you could remind us again what you've got outstanding under the share repurchase authorization and really how you're thinking about how you tackle that share repurchase.

Greg Matz - *Cooper Companies Inc - CFO*

Okay. On the share repurchase, let me just -- we have currently outstanding on that is approximately $185 million on the program.

Larry Kush - *Raymond James - Analyst*

Okay.

Greg Matz - *Cooper Companies Inc - CFO*

And again, I think we will continue to run that program like we've run it over the last year or so. And, there will be opportunities where we believe that it makes sense based on where the stock is at. From a -- the other question you were asking --?

Larry Kush - *Raymond James - Analyst*

Free cash flow.

Greg Matz - *Cooper Companies Inc - CFO*

On the free cash flow.

Larry Kush - *Raymond James - Analyst*

Yes, why guidance was maintained.

Greg Matz - *Cooper Companies Inc - CFO*

I think there's still, from our perspective, there's a lot happening with the equipment purchase that's we're talking about. The CapEx number is a big number. We're looking at the opportunity of moving capital purchases up in order to get the key equipment that we want for our growth in the future. And so, at this point in time, we felt comfortable just leaving the range where it was at as we watched some of that CapEx start to be processed.

Larry Kush - *Raymond James - Analyst*

Okay, that's --.

Bob Weiss - *Cooper Companies Inc - CEO*

I think the incremental earnings, if you will, in the context of the size of that number is more rounding. It wouldn't move the needle that much. And, some of those items that have caused incremental earnings, specifically in the tax area, are more non-cash events.

Larry Kush - *Raymond James - Analyst*

Got it. And, just so we're callibrated, CapEx for the year, how are we thinking about that?

Greg Matz - *Cooper Companies Inc - CFO*

$200 million to $250 million is the range we're giving.

Larry Kush - *Raymond James - Analyst*

Okay, perfect. Thank you.

Operator

Amit Bhalla, Citi.

Amit Bhalla - *Citigroup - Analyst*

Greg, two questions. First, on the gross margin, as you look to the remainder of the year I think you said, or Bob may have said, that you expect gross margin to stay at the current level of 66%. Help me understand why that's not improving. I think you, from what you're saying so far, it does sound like there should be gross margin improvement into -- in the second half of the year.

And, secondly, on the tax in the quarter, I think if I heard you right you said there was a one time impact. Why wasn't that excluded? Why did you take the benefit, which we calculate at about $0.09 in the quarter? Thanks.

Bob Weiss - *Cooper Companies Inc - CEO*

Let me take both of those. First of all, on the gross margin going forward, the 66.2% that we had in the second quarter, as you look forward with our expectation of the roll-out of MyDay and a more robust Avaira family, those are factors that will, in both cases, work against on mix. So, it's as much as anything has to do with mix as opposed to our cost of goods headed down or any other factor. Having said that, we continue to expect Biofinity to be doing well. But, there's going to be a lot of growth in let's say that 1 Day modality in our estimation.

As far as the tax, the reason it's not called out is, quite frankly, if you look at us over the last 10, 15 years, we have had those events fairly routinely. And, in our tax -- in our effective tax rate we continue to set up these reserves. These reserves are coming out of ordinary effective tax rate. They're set up there where we think it's appropriate.

And then, the ultimate determination is made when either there is a settlement or discussion with tax jurisdiction or statute is barred or removed after a period of time. So, that plays part of our operating business and our operating model. And, we have never quoted, nor would we, the portion of what we're accruing that is in our effective tax rate that we're giving you.

Greg Matz - *Cooper Companies Inc - CFO*

Just to add to that too, in that settlement we actually had two years. One of the things that was unusual, and caused that number to be as big as it was, is the fact that normally they would have closed out one year last year. And, what happened is at the end of their audit last year they held the year open and went on to the next year which was a little unusual. So, they waited to close out both years together.

We got a double hit, so to speak, in the current year. The other thing on the gross margin, also still, the Yen is still moving against us. We continue to have that. Keeping the margins relatively flat over the next couple of quarters is still absorbing extra Yen-based impact.

Amit Bhalla - *Citigroup - Analyst*

Okay, thanks.

Bob Weiss - *Cooper Companies Inc - CEO*

Next question.

Operator

Ladies and gentlemen, this will conclude our question-and-answer session for today's conference. I would now like to turn the call over to Bob Weiss for closing remarks.

Bob Weiss - *Cooper Companies Inc - CEO*

Thank you, and I want to thank everyone for joining us today. Hopefully, you were as pleased with our quarter as I was in delivering the results. And, I look forward to updating everyone on progress we're making on our next call which is on September 5, right after the Labor Day weekend. So, until then, have a pleasant summer. Thank you.

Operator

Ladies and gentlemen, that concludes today's conference. Thank you for your participation. You may now disconnect. Have a good day.
