ILMN Q119 Earnings Call

Prepared Remarks – 30 April 2020

Jacquie Ross, Vice President, Communications, IR & CSR:

Good afternoon everyone, and thanks for joining us for our 2020 first quarter results. I sincerely hope that you are keeping well during this time.

During the call today, we will review the financial results released after the close of the market, and offer commentary on our commercial activity, after which we will host a question and answer session. If you have not had a chance to review the earnings release, it can be found in the Investor Relations section of our website at illumina.com. Participating for Illumina today will be Francis deSouza, President and Chief Executive Officer, and Sam Samad, Chief Financial Officer. Francis will share an update on our business and Sam will review our financial results. Of course, we are hosting our call from a number of different locations today, so please bear with us if there are any technical challenges or pauses.

This call is being recorded and the audio portion will be archived in the Investor section of our website. It is our intent that all forward-looking statements regarding our financial results and commercial activity made during today's call will be protected under the Private Securities Litigation Reform Act of 1995.

Forward-looking statements are subject to risks and uncertainties. Actual events or results may differ materially from those projected or discussed. All forward-looking statements are based upon current available information, and Illumina assumes no obligation to update these statements.

To better understand the risks and uncertainties that could cause actual results to differ, we refer you to the documents that Illumina files with the Securities and Exchange Commission, including Illumina's most recent forms 10-Q and 10-K. With that, I'll turn the call over to Francis.

Francis deSouza, President and CEO:

Thank you, Jacquie. Good afternoon everyone and thank you for joining us. I sincerely hope that you and your loved ones are healthy and safe as we collectively work our way through these challenging times.

As a global citizen, and a leader in genomics, Illumina is committed to doing everything we can to support efforts to combat the COVID-19 pandemic, help patients and public health efforts, and accelerate economic recovery. In the earliest stages of the outbreak, Illumina's technology was used by Dr. Fan Wu and the team at the Shanghai Public Health Center to sequence the first complete published viral genome of what was later named SARS-CoV-2. Since then, teams all over the world have been working with Illumina's technology to identify strains and monitor mutations in support of surveillance efforts, to understand therapeutic and host response, and explore sequence-based diagnostic testing, as well as population screening to support back to work programs.

In terms of surveillance, Dr. Trevor Bedford at the Fred Hutchinson Cancer Research Center in Seattle and Dr. Charles Chiu at UCSF are among those monitoring virus transmission and tracking mutations. And we have donated products to the Africa CDC to expand their NGS-based surveillance capabilities for infectious disease in the Democratic Republic of Congo, Egypt, Ethiopia, Ghana, Kenya, Mali, Nigeria, Senegal, South Africa and Uganda, in some cases bringing sequencing capability into the country for the first time.

Susceptibility to COVID-19 is almost certainly, in part, genetic and it's important to understand the interactions between viral and host genetics to potentially identify those individuals most at risk and support the development of therapies and vaccines. We're supporting multiple collaborations with partners including the New York Genome Center, Stanford, and Adaptive Biotechnology, to better understand the evolution of the viral genome, and potential genetic factors determining an immune response. Earlier this week, Genomics Medicine Ireland announced it will sequence COVID-19 positive samples to identify risk-bearing and protective factors for COVID-19.

In terms of testing, while the majority of testing will occur using PCR and Serology-based tests, there are numerous groups looking to multiplex testing using NGS. For example, one of our partners, IDbyDNA, offers clinically validated, NGS-based testing. Additionally, multiple groups are publishing papers describing the performance of NGS assays with plans for clinical validation.

Finally, some customers are working on ultra-high throughput NGS-based screening tests for return to work. While these efforts are early, our teams are working to help customers meet the testing challenges that have been highlighted as critical to enable our economies to sustainably recover without placing individuals at risk.
As we support our customers' efforts, I'm always impressed but rarely surprised by the innovations delivered by the Illumina team. To support COVID-19 work, we have released a number of workflows and data analytics to help identify the virus and track its transmission including:

- A shotgun metagenomics application to enable researchers and academics to detect and characterize SARS-CoV-2 and other novel pathogens for epidemiology. The application also supports the unbiased detection of co-infections, and the profiling of host response genes to study co-morbidities and human immune response;
- An enrichment workflow for Public Health Labs to enable highly accurate detection of SARS-CoV-2 and viral sequence information to optimize containment strategies and identify co-infections of other respiratory viruses that may require different treatments;
- An amplicon workflow to support Public Health Labs studying SARS-CoV-2 epidemiology with co-infections at higher sample volumes; and
- a new software toolkit that makes it easier for researchers to detect and identify SARS-CoV-2 viral sequences and contribute their findings to public databases. We have made this toolkit freely available to anyone who is using an Illumina sequencer.

Illumina's mission to improve human health by unlocking the power of the genome has never been more relevant. I'd like to thank the global Illumina team for their dedication to keeping our employees safe, ensuring supply for those customers who are performing critical work – whether COVID-19 related or not – and doing everything we can to contribute to combating this pandemic.

I'd also like to recognize the many Illumina customers and partners who are working directly to fight COVID-19. We are inspired by your drive, creativity and commitment, and will do whatever we can to maximize the impact of your efforts. With that, I'll move to our quarterly update.

Illumina reported first quarter revenue of $859 million compared to our guidance range of $850 to $855 million. Clearly, there are a lot of moving pieces this quarter, so I will talk about our business in three ways so that we can share many of the insights we have: by region, by customer, and by product.

Starting with the regions, China was the first to be impacted by COVID-19, and was therefore the most impacted in the quarter. As the outbreak grew, our priority was to support customers as they scaled their capabilities for COVID-19-related work. This included the installation of iSeq and MiSeq systems starting in January at one of the CDCs in the hardest hit region, and supporting other CDC locations and hospitals in the country.

As China implemented measures to contain the COVID-19 outbreak, it became difficult for patients to maintain clinical appointments for oncology and NIPT testing. As a result, both sequencing systems and sequencing consumables were lower than expected in China in the first quarter, and total China revenue was $84 million.

We have started to see run volumes increase in China in March and April. It's not back to business as normal, but we are seeing both research and clinical customers returning to their labs in China and scaling up their operations.

EMEA and AMR were resilient to COVID-19 through much of the first quarter and were tracking above our expectations in February. Momentum slowed quickly in mid-March as the wave of closure and shelter in place orders flooded across these regions in the closing weeks. Both EMEA and AMR still beat our expectations for the first quarter, but were clearly impacted by COVID-19.

- First, total system shipments were lower than expected in both AMR and EMEA. Systems tend to be back-end loaded in any given quarter, and system purchases were not considered high priority for many customers at the end of the first quarter.
- Second, we saw some customers pre-emptively stocking up on sequencing consumables.

Total EMEA revenue was $221 million, and total AMR revenue was $477 million.

Finally, APJ delivered revenue of $77 million, with solid sequencing consumable growth, including record shipments in Japan, despite COVID-19 related headwinds. In fact, this was a record quarter for APJ overall, with the highest total revenue ever reported for that region.

We expect Q2 to be an extremely challenging quarter, with revenue declining sequentially in each region, albeit more modestly in China.

On a positive note, Illumina's operations have stayed up and running globally, and – so far – we have been able to overcome any COVID-19 related challenges and deliver products to our customers in a consistent and timely manner.

Moving to a customer view, it is clear that COVID-19 is impacting different customers in different ways, and we have some insights drawn from the volume of runs associated with our connected network of sequencing systems. While not all our systems are connected, we believe this is a useful reference that shows the general activity trend across our installed base. Runs are reported regardless of volume of sequencing output and are not directly correlated to revenue.

First, both research and clinical runs were ramping well throughout the quarter, peaking during the week ending March 14th.

Not surprisingly, the number of research and applied runs started to slow during the week beginning March 15th, especially among academic institutions. This reflects research labs scaling back in response to shelter-in-place requirements, for those not working directly on COVID-19. The decline was rapid in the second half of March, but then stabilized quite quickly, and has been roughly flat since the beginning of April. Overall, research volume is running at close to 55% of what it was in the fourth quarter of 2019.

Moving to clinical, run volume was impacted by COVID-19, but was somewhat more resilient than research. Clinical runs also reached their high point for the quarter during the week ending March 14th. In the week beginning March 15th, clinical run volumes started to decline, albeit more slowly than we saw in research. Unlike some of our research customers, many of our clinical customers are considered essential healthcare services and have remained open, although sample volume is being impacted as patients avoid healthcare facilities.

While more modest, the clinical declines extended for four weeks, and we started to see stabilization in the week beginning April 12th. Clinical volume is currently running at just over 80% of what it was in the fourth quarter of last year. In summary, the shape of the curve has been a little different for research and clinical customers. Research run volume dropped faster, but also stabilized more quickly, and has been roughly flat for the last four weeks. The clinical run volume drop was more gentle, but the duration was longer before stabilizing in the last two weeks.
Both research and clinical run volume increased modestly on a sequential basis in the week beginning April 19th, although it is clearly too early to call any kind of trend.

Finally, moving to the revenue view, total sequencing system revenue of $79 million was down 25% from the same quarter of last year, and substantially below our expectations driven by COVID-19 disruption. Excluding the COVID-19 impact on sequencing systems, we would have comfortably exceeded our sequencing system revenue expectation for the quarter. However, system shipments were down across all families, with the exception of NextSeq 2000 in its first quarter of launch.

First customer shipments of our NextSeq 2000 were delivered – right on time – on March 9th. Orders for the system were in-line with our internal forecast for the first quarter, but shipments were lower than expected because of the COVID-19 disruption at the end of the quarter.

Early adopters of the NextSeq 2000 included both existing and new Illumina customers in research and academic institutions across all four regions. Initial NextSeq 2000 applications included food safety, genetic disease, cancer, and COVID-19 research. We did not ship any new NextSeq 2000s to HiSeq conversion customers in the first quarter. The sales funnel so far is consistent with our expectation for very modest cannibalization of NovaSeq conversions among remaining HiSeq customers in the quarters ahead. Finally, almost half of the new NextSeq 2000s shipped were too new to Illumina system customers, ahead of our expectations.

Sequencing consumable revenue of $553 million grew 15% from the same quarter last year and was stronger than expected. Less than half of the sequencing consumable “beat” was associated with COVID-19 related stocking among our clinical customers. NovaSeq pull-through per system was higher than the same quarter last year and comfortably within the previous guidance range of $1.1 to $1.2 million per NovaSeq per year. We do expect NovaSeq pull-through to step down meaningfully in the second quarter.

Pull through for both MiSeq and our NextSeq 500 and 550s was flat with last quarter, and MiniSeq was below its targeted pull through range.

Sequencing service and other revenue was $128 million, up 13% due to higher licensing revenue compared to the same quarter last year.

Overall, sequencing revenue of $760 million was slightly ahead of our expectation, and represented 88% of total revenue.

Moving to arrays, total array revenue was $99 million, down 33% from the same quarter last year, and in-line with our expectations for the first quarter. Our array services business grew sequentially as we expected, given the normal

seasonality associated with DTC, but declined year-over-year. Array consumables declined both sequentially and year-over-year, consistent with our expectations of the DTC market.

In summary, our business was impacted negatively overall by over $20 million in the first quarter, primarily driven by sequencing instruments, but this was partially offset by a modest contribution from COVID-19 related stocking, and broader strength across sequencing consumables and sequencing service and other.

With that, I'll hand it over to Sam to discuss the financials in more detail.

Sam Samad, SVP and CFO:

Thanks, Francis. And thanks to you all for joining us today. I really hope you and your families are safe and healthy. As discussed, first quarter revenue grew 2% year-over-year to $859 million, slightly ahead of our expectations with stronger sequencing consumables and sequencing services and other, offsetting softer than expected sequencing system revenue.

Moving to gross margin and operating expenses, I will highlight non-GAAP results that include stock-based compensation. I encourage you to review the GAAP reconciliation of these non-GAAP measures which can be found in today's release and the supplementary data available on our website. Please note that all subsequent references to net income and earnings per share refer to the results attributable to Illumina shareholders.

Non-GAAP gross margin of 73.0% was higher than our expectations, with lower sequencing system revenue and higher sequencing consumable and other revenue resulting in a more favorable mix in addition to increased fixed cost leverage as we increased safety stock volumes.

Non-GAAP operating expenses of $339 million were down $33 million from the fourth quarter of 2019, and down $24 million from the first quarter of 2019. This was lower than we expected due to delayed project spend, reduced labor-related expenses and less travel.

Non-GAAP operating margin was 33.6%, up from 31.0% last quarter, and better than expected.

The non-GAAP tax rate of 16.1% was down from last quarter and lower than expected due to prior year return adjustments and discrete tax benefits related to the release of tax reserves.

For the first quarter of 2020, GAAP net income was $173 million, or $1.17 per diluted share, and non-GAAP net income was $243 million, or $1.64 per diluted share.

Additionally in the first quarter:

- Cash flow from operations was $281 million;
- First quarter capital expenditures were $40 million and free cash flow was $241 million.
- DSO of 50 days compared to 55 days last quarter due to more favorable revenue linearity.

We ended the quarter with approximately $3.3 billion in cash, cash equivalents, and short-term investments. This is down from $3.4 billion reported at the end of 2019, due to $187 million in share repurchases in the first quarter, and $132 million for the reverse termination fee and continuation advances paid to Pacific Biosciences. The expenses related to the PacBio payments are excluded from our non-GAAP results.

Our weighted average diluted share count for the quarter was approximately 148 million. We have $563 million available for share repurchases under our current plan.

Looking forward, we have withdrawn all our previous guidance due to the uncertainties around the severity and duration of the COVID-19 outbreak. To be very clear, this includes our revenue and EPS guidance, in addition to any other forward-looking comments we have made on NovaSeq or other system pull-through, NextSeq 1000 and 2000 shipments, and popgen expectations for the year.

One month in, we can see that the second quarter impact will be substantially greater than the impact we experienced in the first quarter, and we are planning accordingly. As mentioned before, we expect revenue to decline sequentially in every region in the second quarter, with the smallest dollar decline expected in China, and the largest in AMR.

While we have so far been able to produce and deliver to our customers with minimal delays in the first quarter, we note a higher risk of transportation delays associated with border closures and a drop-in air freight capacity linked to fewer passenger flights. Again, these are not impacting our business today, but are risks as we look forward.

Given the wide range of possible outcomes, we are not offering guidance on second quarter revenue at this time. Even though we are not providing second quarter guidance, we can share some qualitative comments about factors that will impact our P&L in the second quarter. For example, it is clear that substantially lower revenue will lower our gross margin, so you should expect a lower gross margin in the second quarter on both a sequential and year over year basis.

In terms of operating expense, we remain committed to investing strategically to ensure that we protect the strength of our business when we emerge on the other side of the COVID-19 disruption. As a result, we expect operating expenses to be roughly flat on a dollar basis compared to the second quarter of last year. Illumina is an innovation engine, and – while we have deprioritized some work – we will do everything we can to retain our most important product development timelines.

That said, we are managing expenses very carefully. In the near-term, there are savings associated with restricted discretionary expenses including travel, marketing events, and consulting; and slower hiring associated with a lengthening hiring cycle. We are also reducing spend on contract and temporary labor in certain functions. Finally, we have delayed certain non-R&D projects and delayed or canceled certain capital expenditure projects. Compared to our original budget for the year, second quarter operating expenses have been reduced by more than $40 million.
We are also preparing for additional cost saving opportunities if shelter-in-place orders remain prevalent into the third quarter. While we are all hoping for loosening of restrictions in the near future, we have planned for a range of scenarios that we can activate if needed. We will monitor the situation carefully throughout the rest of the second quarter to assess whether we need to take more aggressive actions more quickly. This includes a careful reassessment of our capital investment plans and gating programs in some cases.

In the meantime, we continue to hire and on-board new team members virtually, but retain the flexibility to pause or limit hiring, or slow other investments if the pandemic is prolonged.

With that, I'll hand the call back over to Francis.

Francis deSouza, President and CEO:

Thank you, Sam.

We are mindful of the balance between navigating the uncertain duration of this pandemic and ensuring that we don't do anything that slows our pipeline of innovation, or otherwise inhibits our ability to meet the needs of our customers.

We are hopeful that the biggest impact will be felt in the second quarter, but ensuring that we are well prepared if it extends into the second half of the year.

As challenging as the current environment is, we don't see any change to the long-term trajectory of sequencing adoption and demand. Clinical testing has proved quite resilient even in these challenging times, highlighting the importance and medical value of genomic testing.

While it's true that some labs have paused their research operations, it's also clear that a number of research labs are switching to COVID-19 related projects. Clearly, we have a lot of work to do to find our way out of this pandemic, and then prepare for the next one. It's reassuring to see that governments around the world are committing resources to this important work. For example, the last two relief packages from the U.S. government has allocated over $1 billion to the CDC, with the specific goal of building out surveillance and other capabilities in the hope we can be better prepared the next time. We do not believe that there is a technological limitation to getting this done. And it is clear that sequencing will be at the heart of the solution.

It is a challenging time to be running a business. But the Illumina community – including our employees, our suppliers, our partners, and our customers – has never been more united to a cause, or more convinced of the importance of our shared work. We are leaving no stone unturned as we actively look for more and more ways to contribute to the effort.

With that, we can start the Q&A.

Statement regarding use of non-GAAP financial measures

The company reports non-GAAP results for diluted net income per share, net income, gross margins, operating expenses, operating margins, other income, and free cash flow in addition to, and not as a substitute for, or superior to, financial measures calculated in accordance with GAAP. The company's financial measures under GAAP include substantial charges such as amortization of acquired intangible assets, non-cash interest expense associated with the company's convertible debt instruments that may be settled in cash, and others that are listed in the itemized reconciliations between GAAP and non-GAAP financial measures included in this press release. Management has excluded the effects of these items in non-GAAP measures to assist investors in analyzing and assessing past and future operating performance. Additionally, non-GAAP net income attributable to Illumina stockholders and diluted earnings per share attributable to Illumina stockholders are key components of the financial metrics utilized by the company's board of directors to measure, in part, management's performance and determine significant elements of management's compensation.

The company encourages investors to carefully consider its results under GAAP, as well as its supplemental non-GAAP information and the reconciliation between these presentations, to more fully understand its business. Reconciliations between GAAP and non-GAAP results are presented in the tables of this release.

Use of forward-looking statements

This document may contain forward-looking statements that involve risks and uncertainties. Among the important factors to which our business is subject that could cause actual results to differ materially from those in any forward-looking statements are: (i) the impact to our business and operating results of the COVID-19 pandemic; (ii) changes in the rate of growth in the markets we serve; (iii) the volume, timing and mix of customer orders among our products and services; (iv) our ability to adjust our operating expenses to align with our revenue expectations; (v) our ability to manufacture robust instrumentation and consumables; (vi) the success of products and services competitive with our own; (vii) challenges inherent in developing, manufacturing, and launching new products and services, including expanding or modifying manufacturing operations and reliance on third-party suppliers for critical components; (viii) the impact of recently launched or pre-announced products and services on existing products and services; (ix) our ability to further develop and commercialize our instruments and consumables, to deploy new products, services, and applications, and to expand the markets for our technology platforms; (x) our ability to obtain regulatory clearance for our products from government

agencies; (xi) our ability to successfully partner with other companies and organizations to develop new products, expand markets, and grow our business; (xii) our ability to successfully identify and integrate acquired technologies, products, or businesses; and (xiii) the application of generally accepted accounting principles, which are highly complex and involve many subjective assumptions, estimates, and judgments, together with other factors detailed in our filings with the Securities and Exchange Commission, including our most recent filings on Forms 10-K and 10-Q, or in information disclosed in public conference calls, the date and time of which are released beforehand. We undertake no obligation, and do not intend, to update these forward-looking statements, to review or confirm analysts' expectations, or to provide interim reports or updates on the progress of the current quarter.