ILMN Q220 Earnings Call

Prepared Remarks – 6 August 2020

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

Good afternoon everyone, and thanks for joining us for our 2020 second quarter results.

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. Similar to last quarter, we are hosting our call from a number of different locations, 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 today.

As expected, the second quarter was tough in the context of our original 2020 plan, but nonetheless a quarter of strong execution in the current environment that further strengthens our foundation for future expansion. I have been proud to see how our employees have pivoted and flexed to support customers, how we have stepped up what was already an aggressive innovation engine, and how we have supported each other and our communities through this pandemic. As we navigate the near-term disruption, we remain focused on the long-term opportunity for Illumina and for sequencing which – if anything – is larger today than it was six months ago.

To summarize our second quarter experience and outlook:

- Our second quarter revenue of $633 million was down 25% from a year ago, as our customers around the world continued to be impacted by the pandemic. We are seeing indicators of gradual recovery and, barring an

unexpected development in the course of the pandemic, the second quarter should represent the revenue floor for the year. Further, we expect sequential revenue growth in the third and fourth quarters.

- Second, despite lower patient visits, our clinical business remains more resilient than research which continues to be more impacted by ongoing shelter-in-place restrictions.

- Third, infectious disease is emerging as an additional, long-term focus area for genomics. Illumina has responded quickly, with 3 workflows, including software tools and COVIDSeq, our diagnostic test for COVID19, which went from concept to authorization in less than 60 days. Given the timing, these contributed very modestly to revenue in the second quarter, and we are encouraged by the interest we are seeing so far in the third quarter.

- Finally, and most importantly, we believe that the long-term opportunity for sequencing is expanding. While COVID-19 has had a negative short-term impact on our customers' ability to operate, this shared experience is broadening awareness and appreciation of the value of genomic insights. Studies including, GEL's 35,000 patient study in the UK, could ultimately accelerate the adoption of genomic tests into routine clinical use for infectious disease and surveillance.

Looking to the second half of 2020 specifically, sequencing consumables, which make up most of our revenue, remain correlated with shelter-in-place activities, and recovery therefore depends on how quickly our customers get back into their labs. That said, we are encouraged by the momentum in the business as we move into the second half of the year:

- Sequencing consumable run-rates are improving, and some of our clinical customers are at or above their run-rates from the fourth quarter of last year.

- Sequencing system placements increased sequentially, including higher NovaSeq shipments. Additionally, NextSeq2000 shipments beat our second quarter expectations.

- Population genomics initiatives are continuing to move forward. All of Us, for example, has received the necessary IDE from the FDA, and will start sequencing and genotyping later this quarter.

- And, beyond research, COVID-19-related sequencing for both diagnosis and screening is at the earliest stages of adoption, and could scale more meaningfully in the second half of the year.

Sequencing continues to play a critical role in understanding the SARS-CoV-2 virus, the transmission dynamics of the pandemic, the development of effective treatment and vaccines, and the interactions between host and virus with respect to transmission and virulence. In addition, we are seeing growing interest in leveraging sequencing to help address the need for increased diagnostic and screening testing capacity.

To contribute to testing capacity, Illumina urgently developed COVIDSeq, the first NGS-based diagnostic for COVID-19. We received emergency use authorization from the FDA on June 7th and shipped to a few early access customers towards the end of the second quarter. PathGroup, for example, intends to launch towards the end of this quarter and scale through the end of 2020. COVIDSeq runs on our NovaSeq and – in addition to a diagnostic yes or no - provides a full viral sequence for most positive samples. This information can be critical to understanding community transmission patterns in order to better control regional outbreaks.

We continue to extend the utility of COVIDSeq with a series of amendments that will add saliva, improve automation and de-risk supply chain. In the immediate term, we have submitted an amendment to the current authorization for our existing COVIDSeq test that simplifies the workflow with an additional RNA extraction method to de-risk the supply chain and extend the test beyond our NovaSeq by adding NextSeq. This will enable lower throughput labs to offer COVID-19 diagnostic testing locally, which could supplement current PCR test providers who are experiencing turnaround times of up to 10 business days.

Looking forward, and with Illumina's COVIDSeq supply scaling up, we are in discussion with dozens of customers in more than 10 countries, with a number of these actively evaluating COVIDSeq.

For example, the Institute of Genomics and Integrative Biology in New Delhi just completed their first clinical validation of COVIDSeq and reported sensitivity of more than 98%, and an increase in diagnostic yield of between 8 and 10% compared to PCR. The team is interested in COVIDSeq as a means to increase available front-line testing, while also gaining access to the viral genome data that can be used to monitor transmission of the virus.

In addition to COVIDSeq, we're pleased that Ginkgo and Helix, were among the 7 recipients of funding from the NIH's Rapid Acceleration of Diagnostics initiative. This underscores the potential for sequencing-based diagnostic tests to scale and diversify testing beyond PCR, which we believe will be increasingly important as we head into the Fall flu season.

Moving to screening, it remains to be seen how widely screening programs are adopted, but it is clear that a number of programs will scale in the third quarter.

- Testing for America last week announced a partnership with the historically black colleges and universities to develop return-to-campus initiatives for the academic institutions within the Thurgood Marshall College Fund and the United Negro College Fund family. Delaware State University, for example, started its pilot screening program a few weeks ago, with plans to test up to 3,000 students and educators a week.

Back to the quarter, and starting with the regional results, all regions were impacted by prolonged closures or reduced operations at research labs, and also in some cases by temporary re-allocation of resources to PCR testing for COVID19.

China revenue of $79 million was down $5 million sequentially, consistent with our expectation for a relatively modest decline. COVID-19 headwinds were driven by the research market with extended closures among some universities and research institutes that we expect to continue into the third quarter. Clinical, however, has shown some resilience through the pandemic with growth both sequentially and year-over-year – driven by reproductive health. Oncology testing is still below pre-COVID-19 levels but improving.

EMEA revenue of $168 million was largely in line with our expectations and reflected significant sequential declines in both research and clinical sequencing consumables. Research headwinds were driven by lab closures, while some other customers redirected resources to non-sequencing based COVID-19 diagnostic testing.

As expected, the Americas region saw the largest sequential dollar impact from COVID-19, and was down $142 million from last quarter to $335 million. Compared to April, more academic and government labs are resuming operations, but most are still operating well below pre-COVID-19 levels. Clinical continues to be more resilient, with some customers reporting lower clinical samples associated with shelter-in-place restrictions.

Finally, the Asia Pacific region reported revenue of $51 million compared to $57 million in the second quarter of 2019 as research labs reduced activity.

Moving to the customer view, we continue to track sequencing run-rates as an indicator of general activity but remind you that this is not directly correlated to revenue. It's clear that while customers navigate this pandemic, many are maintaining a lower level of sequencing consumable inventory than before. As a result, shipments and therefore revenue are lagging the recovery we are seeing in run-rates.

That said, in clinical, we shared that run volume at the end of April was about 80% of the run-rate in the fourth quarter of last year. Clinical run-rates for the second quarter of this year averaged 84% of the Q419 run-rate. The trend is one of modest recovery, but with significant variation from week to week. Within clinical, reproductive health continues to be the most resilient, followed by oncology.

Moving to research, second quarter run-rate improved from about 55% at the end of April to about 65% of the Q419 run rate, but clearly remains significantly impacted by the pandemic. Weekly run-rates among research customers are more variable than clinical.

While commercial disruption has been unavoidable, the broader Illumina team continues to execute against our strategic priorities, with new product releases and acquisitions that are intended to further enhance our customers' application portfolio and ease of use, and expand our market opportunity.

- Early feedback on NextSeq 2000 has been very positive, with customers reporting that the sequencers outperform specifications with the excellent data quality that they have come to expect from Illumina. Despite the shift to the virtual world, our team has done a terrific job of installing new systems and getting customers up and running which speaks to the strength of our support organization as well as the underlying engineering and product design. Additionally, customers are showing continued interest in the P3 flow cell which remains on track for a fourth quarter launch.

- As noted earlier, we obtained the first Emergency-Use Authorization for a sequencing-based COVID-19 diagnostic test in early June, highlighting our versatile R&D and regulatory capabilities.

- In early July, we launched the TruSight Software Suite for genetic disease that enables labs to accelerate time to potentially transformative genomic insights from weeks to hours. The TruSight Software Suite helps customers quickly sort through millions of variants to identify hard-to-find genomic conditions. We believe that this TruSight Software Suite could - over time – become part of a new standard of care for newborns suspected of a genetic condition. And there is already broad – and growing – reimbursement offered for genetic disease testing.

- As the opportunity for clinical sequencing grows, we continue to identify and address bottlenecks to adoption, and this has resulted in innovation across the entire sequencing workflow. Most recently, we announced our new DNA PCR-free prep which reduces library prep time by as much as 75%. This accelerates time to result and improves lab efficiencies, which are both even more important in the context of clinical samples.

- At the other end of the workflow, we continue to find ways to help our customers store, manage and analyze the vast amounts of data generated by our sequencers. With that in mind, we closed two technology acquisitions in June and July that – combined with our existing software solutions – improve the efficiency and scalability of processing and sharing data. BlueBee offers software solutions that enhance users' ability to extract insights from genomic data stored in Illumina's Analytics Platform. And Enancio brings proprietary, loss-less genomic data compression software that reduces storage footprint five-fold and will be integrated directly into the DRAGEN workflow.

- Outside of the sequencing workflow, but important nonetheless, we've received positive feedback on our new sustainable reagent packaging – which will divert almost 250,000 cubic feet of foam packaging from landfills each year.

Finally, I'm pleased to announce some enhanced features and new pricing for our NovaSeq reagent kits. The new reagent kits deliver longer shelf life and extra cycles extending our performance lead in the high throughput market. Additionally, the new kit offers more accessible pricing for any NovaSeq user, bringing the $600 genome into reach for all our customers.

These changes represent Illumina's ongoing commitment to sequencing innovation to enable deeper sequencing, adoption of more data intensive applications like whole genome sequencing, single cell and liquid biopsy, and larger cohorts to increase the statistical power of studies.

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

Sam Samad, SVP and CFO:

Thanks, Francis.

As discussed, second quarter revenue declined 25% year-over-year to $633 million as the pandemic impacted our research customers in particular.
Total sequencing system revenue of $88 million was slightly ahead of our expectations with stronger than expected NextSeq 2000 shipments. Shipments for NovaSeq, NextSeq 2000, MiSeq and MiniSeq all increased sequentially.

We continue to see NextSeq 2000 adoption across a broad range of clinical and research applications, including oncology testing, single-cell, molecular pathology, and infectious disease including COVID-19 research. For the second quarter, most of the NextSeq2000 shipments were legacy NextSeq conversions, and – cumulatively to date – roughly a quarter of the new systems have been shipped to new-to-Illumina customers.
Sequencing consumable revenue was $387 million, with many customers still operating below pre-COVID levels. Of interest, clinical sequencing consumable revenue represented close to 50% of total sequencing consumables, given the greater pandemic impact we're seeing among research customers.

Sequencing service and other revenue was $91 million, down sequentially due to lower licensing revenue, and down year over year due to lower sequencing service revenue.

Overall, sequencing revenue was $566 million and represented 89% of total revenue.

Total array revenue was $67 million, down 39% from the same quarter last year and down 32% from the first quarter of 2020, in part due to our lower expectations of the DTC market and its normal seasonality in addition to COVID-19 related headwinds.
Moving through the P&L, as always, 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 68.6% was lower, as expected, on both a year-over-year and sequential basis, due to lower revenue which generated less fixed cost leverage, and higher freight costs associated with the pandemic.

Non-GAAP operating expenses of $334 million were down $5 million from the first quarter of 2020, and $26 million lower than the second quarter of 2019. This was lower than expected due to an adjustment to stock-based compensation expense to account for updated EPS projections.

Non-GAAP operating margin was 15.8%, down from 33.6% last quarter.
The non-GAAP tax rate of 18.5% was up from last quarter and prior year due to a higher income mix in jurisdictions with a higher tax rate.

For the second quarter of 2020, GAAP net income was $47 million, or $0.32 per diluted share, and non-GAAP net income was $92 million, or $0.62 per diluted share. On a per share basis, our GAAP results include $0.61 for two discrete tax expense items. The first of these relates to a valuation allowance established against the deferred tax asset for California R&D tax credits, and the second reflects finalization of the Altera court case which determined share-based compensation must be included in intercompany cost-sharing payments. This is partially offset by $0.38 on a per share basis from Other income, which includes $69 million in unrealized gains from equity investments.

Additionally in the second quarter:

- Cash flow from operations was $240 million;

- Capital expenditures were $38 million and free cash flow was $202 million.

- DSO of 55 days compared to 50 days last quarter, in part, due to less favorable revenue linearity and lower revenue.

- We repurchased $143 million of common stock

We therefore ended the quarter with approximately $3.3 billion in cash, cash equivalents, and short-term investments.

Our weighted average diluted share count for the quarter was approximately 148 million. We have $420 million available for share repurchases under our current plan. Additionally, our 2021 notes became convertible from July 1st through September 30th, 2020, and – as a reminder, the dilutive effect of the convertible notes have been included in our diluted average share count since the second quarter of 2018.

We continue to believe that the uncertainties around the severity and duration of the COVID-19 pandemic, and the impact that has on our research customers in particular, makes it challenging to provide quarterly or full year outlooks at this time.

Directionally, we can share that we expect:

- Sequencing run volumes for our clinical customers to modestly improve from the 84% reported in the second quarter;

- For research and applied, we remain cautious and expect run volumes to improve modestly over the 65% reported in the second quarter;

- We expect sequencing instrument revenue to grow modestly on a sequential basis; and

- We expect array revenue to be flat to slightly up.

In terms of regional performance, we expect sequential growth in every region in the third quarter. While some regions are recovering more quickly than others, there will certainly be headwinds across all regions, and, when compared to the third quarter of 2019, we expect revenue in all regions to be lower, with the exception of APJ which is expected to be about flat.

For the third quarter of 2020, we expect non-GAAP EPS to be modestly higher compared to the second quarter of 2020 reflecting:

- A gradual improvement in revenue,

- A sequential decline in non-GAAP gross margin, in part driven by the adjustment to stock-based compensation in the second quarter and increased field service activity as labs reopen, and,

- An increase in non-GAAP operating expenses, primarily driven by the adjustment to performance-based compensation in the second quarter.

While we expect operating expenses to grow sequentially in the third quarter, we remain thoughtful and deliberate about *where* we invest. This means continuing to invest in R&D projects and utilizing our balance sheet to pursue growth opportunities. As a genomic technology leader, we believe we have an obligation to invest in innovation, regardless of short-term revenue headwinds.

But, at the same time, we'll balance this in other areas, by pausing or delaying certain capital expenditures and limiting other discretionary spend.

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

Francis deSouza, President and CEO:

Thank you, Sam.

While the near-term disruption is challenging as we continue to navigate the pandemic, we remain as bullish as ever on the opportunity ahead for Illumina.

- The long-term opportunity for sequencing is expanding as the need for more infectious disease research and surveillance capabilities comes into focus.

- Innovation remains our northstar, and we will continue to partner with our customers, as well as innovate internally, to ensure that sequencing-based applications are contributing to global efforts to combat this pandemic, and whatever combination of research, diagnostic, screening and surveillance applications is the most impactful.

- Our competitive positioning is strong, with the recent preliminary injunction helping protect our intellectual property here in the United States.

- And, looking beyond the pandemic, we remain unwavering in our commitment to innovation, and to investing appropriately to progress our technology pipeline and continue to deliver gold standard sequencing products to market.

My thanks to our customers, and to our employees who are demonstrating resilience and flexibility as we work through this pandemic together.

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.