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MTLS - Q2 2019 Materialise NV Earnings Call

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CORPORATE PARTICIPANTS

Johan Albrecht *Materialise NV - Executive VP & CFO*

Peter E. Leys *Materialise NV - Executive Chairman*

Wilfried Vancraen *Materialise NV - Founder, CEO & Director*

CONFERENCE CALL PARTICIPANTS

Gregory K. Ramirez *Bryan Garnier & Co Ltd, Research Division - Analyst*

Jason Vincent Celino *KeyBanc Capital Markets Inc., Research Division - Associate*

Troy Donavon Jensen *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Harriet C. Fried *Lippert/Heilshorn & Associates, Inc. - SVP*

PRESENTATION

Operator

Good morning, ladies and gentlemen, and welcome to the Q2 2019 Materialise Financial Results Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to turn the conference over to your host, Ms. Harriet Fried of LHA. You may begin.

Harriet C. Fried - *Lippert/Heilshorn & Associates, Inc. - SVP*

Thank you for joining us today for Materialise's quarterly conference call. With us on the call are Fried Vancraen, Founder and Chief Executive Officer of Materialise; Peter Leys, Executive Chairman; and Johan Albrecht, Chief Financial Officer.

Today's call and webcast are being accompanied by a slide presentation that reviews Materialise's strategic, financial and operational performance for the second quarter of 2019. To access the slides, please go to the Investor Relations section of the company's website at www.materialise.com. The earnings press release issued earlier this morning can also be found on that page.

Before we get started, I'd like to remind you that management may make forward-looking statements regarding the company's plans, expectations and growth prospects, among other things. These forward-looking statements are subject to known and unknown uncertainties and risks that could cause actual results to differ materially from the expectations expressed, including competitive dynamics and industry change. Any forward-looking statements, including those related to the company's future results and activities, represent management's estimates as of today and should not be relied upon as representing their estimates as of any subsequent day. Management disclaims any duty to update or revise any forward-looking statements to reflect future events or changes in expectations. A more detailed description of the risks and uncertainties and other factors that may impact the company's future business or financial results can be found on the company's annual report on Form 20-F filed with the SEC. Finally, management will discuss certain non-IFRS measures on today's call. A reconciliation table is contained in the earnings release and at the end of the slide presentation.

And with that, I'd like to turn the call over to Peter Leys. Go ahead, please, Peter.

Peter E. Leys - *Materialise NV - Executive Chairman*

Thank you, Harriet, and thank you, everyone, for joining us today. You will find an agenda for our call on Slide 3. As always, I'll begin with a brief recap of our results for the quarter after which Fried will come on to discuss some of the many growth initiatives in Materialise Medical, including, obviously, the investments we made just last week in Engimplan, a Brazil-based manufacturer of cranio-maxillofacial, or CMF, and orthopedic



implants and instruments. After that, Johan will go through our second quarter results in more detail, and then I will come back to review our financial guidance for 2019. When we've completed our prepared remarks, we will be happy to respond to any questions that you may have.

Now turning to Slide 4, you will see the highlights of our second quarter results. Despite the macroeconomic environment that remains challenging, Materialise continues to grow. Our total revenue rose 7%. Our consolidated adjusted EBITDA was 10.5%, and we were, again, very close to the breakeven point. Materialise Medical continues to perform strongly, with revenues growing 17% quarter-over-quarter and with an EBITDA margin of almost 19%.

The revenues of Materialise Manufacturing grew by 5% for a double-digit EBITDA margin of more than 11%. This quarter, Materialise Software performed below our expectations, with a growth of 2% and an EBITDA margin of 22%.

And I'll now turn the call over to Fried, who will, as I explained earlier, among other things, expands on the investment in Engimplan that we announced last week. Fried?

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Good morning and good afternoon to everyone. Thank you for joining us today. Our strategy to invest in a select number of vertical applications of 3D printing in the medical field has been very successful, and it's evidenced by the continuing strong results of Materialise Medical. Going forward, we intend to continue following that course. I would like to expand on a number of initiatives that are currently ongoing with Materialise Medical and that further execute and build on that strategy.

First, our recently announced investment in Engimplan perfectly fits our vision to invest in meaningful applications of 3D printing, more particularly, this initiative underscores our commitment to continue to invest in the verticals of cranio-maxillofacial surgery and orthopedic applications of additive manufacturing. Engimplan develops, manufactures and sells through a network of distributors, its proprietary CMF and orthopedic, which are mainly spine-related implants and instruments in Brazil, a large market with significant growth potential that is not covered by our international collaboration agreements.

While Engimplan's product portfolio currently consists mainly of standard products that have certain custom solutions, including their own patient-specific TMJ implant. Importantly, Engimplan is a very innovative company that is on the verge of introducing metal 3D printing in its production process. By including some of our own software and hardware solutions into Engimplan's product portfolio and by adding our technological expertise to Engimplan's planned production process, we believe we can create a lot of synergies and further strengthen Engimplan's market share in Brazil. We acquired a 75% stake in Engimplan through a mix of existing and new shares. The remaining 25% remains with the founding family that stays in charge of the company's daily management.

Turning now to Slide 6. Another Materialise Medical initiative are Mimics Enlight Medical cardiovascular planning suite offers a good example of how we are leveraging the strengths of our Mimics Innovation Suite to provide concrete solutions to specific issues in selective medical verticals.

Mimics Enlight Medical, which was developed in collaboration with Henry Ford Health System in Detroit, enables clinicians to reliably plan and screen patients for structural heart and vascular therapy. The first release of Mimics Enlight Medical supports clinicians in planning complex transcatheter mitral valve replacement procedures, allowing them to determine the appropriate size and positioning of the TMVR devices and to better plan surgical strategies to play in these devices.

Mimics Enlight Medical received FDA clearance in June 2019 and a commercial launch is in the U.S., currently targeted for later this month. Other planning tools that we have built from our Mimics platform include our shoulder and our knee planning tools. Similar initiatives are ongoing, including in the field of pulmonology.

Another promising program that is running within our Medical segment is our collaboration with the University of Michigan to develop and commercialize a 3D print tracheal splint to help children suffering from tracheobronchomalacia, a life-threatening congenital area disorder.



The design of this tracheal splint is also done with our Mimics Innovation Suite technology. The device has been accepted into the breakthrough device program in the U.S., formerly known as Expedited Access PMA. Today, the University of Michigan has treated 22 children with this device under the FDA's Expanded Access Program, also known as compassionate use.

While the majority of our research and development efforts in the medical field are expensed, we also capitalize certain development expenses, in particular, in relation to our tracheal splint project because of the exceptional results and the development of our Mimics Enlight planning suite.

Following a receipt of the FDA clearance of our mitral valve implant, we stopped capitalizing the development expenses associated with this solution because this version is now ready for commercialization.

At this point, Johan will come on to give you more details of our second quarter financial results.

Johan Albrecht - *Materialise NV - Executive VP & CFO*

Thank you, Fried. I'll begin with a brief review of our consolidated revenue on Slide 7. As a reminder, when we refer to sales in our presentation, we mean revenues plus deferred revenues. Also, please note that unless otherwise stated all comparisons in this call are against our results for the second quarter of 2018.

As Peter mentioned in his opening remarks, in this year's second quarter, we generated a 7% increase in revenue, driven by our Medical segment. Deferred revenue from annual software sales and maintenance contracts increased EUR 2.2 million compared to end 2018. For the quarter, Materialise Software accounted for 19% of our total revenue, Materialise Medical for 30% and Materialise Manufacturing for 51%. Cross-segment revenue from software products accounted for 29% of our total revenue.

Moving to Slide 8. You will see our consolidated adjusted EBITDA numbers for the first quarter. Consolidated adjusted EBITDA decreased 3% from EUR 5,216,000 to EUR 5,059,000. Our EBITDA margin changed from 11.6% to 10.5%. Unlike the previous period, the 2019 Q2 EBITDA included a positive effect of EUR 644,000 by the new IFRS 16 Accounting Standard that requires us to capitalize certain lease expenses as of 2019.

This new accounting standard has little impact on our operating profit, as depreciation expenses increased by almost the same amount. The increased operating expenses, reflecting our continued investment in sales and marketing capacity, research and development, regulatory initiatives, counterbalance the growth of our top line.

Slide 9 summarizes the results of our Materialise Software segment. The revenue was up by 2% or EUR 189,000. Recurring revenue was up 23%. Nonrecurring revenue was down 14%, affected amongst others by delayed OEM sales. The combination of lower nonrecurring revenue with a continued expansion in our sales and marketing capacity and R&D initiatives have led to a decrease in the segment's EBITDA to EUR 2.1 million from EUR 2.9 million in last year's period. EBITDA margin decreased to 22% compared to 31% in last year's period.

Moving now to Slide 10. You will see that total revenue in our Materialise Medical segment grew 17% for the quarter to EUR 14.5 million. Revenue from Medical Device solutions rose 13%, accounting for 67% of the total segment's revenue. Growth was boosted by direct sales of all of our medical device business lines. Revenue from our medical software, which accounted for 33% of the segment revenue grew 28%. EBITDA for the Medical segment was EUR 2.7 million compared to EUR 2.1 million. The EBITDA margin was almost 19% as compared to 17.1%.

Now let's turn to Slide 11 for an overview of the Q2 performance of our Materialise Manufacturing segment. Their revenue was up by 5%. Increase in our traditional manufacturing business, excluding ACTech, amounted to 7.7%, driven by growth in end-part manufacturing, confirming the positive growth since Q4 2018. EBITDA rose 25%, resulting in an EBITDA margin of 11.5%. This EBITDA growth reflected improved operational excellence. In the second quarter of 2019, we added 4 printers as compared to the previous quarter, which brings the total amount of printers that we have in production in our manufacturing and medical segments to 192.

Slide 12 provides the highlights of our income statement for the second quarter. Both revenue and gross profit grew 7% compared to last year's period. In total, sales and marketing, G&A and research and development spending rose by 8.4% over the prior year period. Sales and marketing



rose by 11%, G&A increased 7% and R&D rose slightly by roughly 5%. This R&D cost increase excludes expenditures in Q2 2019 of EUR 366,000 that were capitalized as intangible assets, and that's from the tracheal splint and Mimics Enlght Medical initiatives that I've already referred to. In total, the intangible assets related to those 2 development initiatives amount to EUR 1,380,000 on our balance sheet at the end of the second quarter 2019.

Net other operating income decreased by EUR 470,000 to EUR 1.4 million compared to EUR 1.8 million, reflecting a negative variance from miscellaneous elements that were particularly high in last year's period. The group's operating profit was at breakeven point, positive EUR 36,000.

Net financial result was negative EUR 190,000 compared to a negative EUR 375,000 last year. The variance primarily reflects the positive impact of the strong U.S. dollar, mainly on the portion of the company's deposits. Income tax amounted to EUR 61,000 compared to EUR 42,000 in the second quarter 2018.

Now please turn to Slide 13 for a recap of balance sheet and cash flow highlights. Our balance sheet remains strong with cash of EUR 108.9 million compared to EUR 115.5 million as of end 2018. The decrease of cash reflects our capital at work, with debt reimbursement, motor capital expenditures, but not all finance, and the payment of EUR 2.5 million convertible loan we extended in Q1 to Fluidica that we referred to in our previous earnings call. Total debt rose EUR 1.7 million from year-end 2018 to \$107.7 million. This debt includes EUR 5.1 million of total lease liabilities from the new accounting standard IFRS 16. On a comparable basis, gross debt decreased EUR 3.4 million in the first half of this year.

Capital expenditures amount to EUR 3.1 million compared to EUR 4.8 million in last year's period. Approximately half of these expenses have been financed to EUR 3.1 million, include EUR 344,000 capitalized development costs explained above. Cash flow from operating activities for the quarter was flat at EUR 4.8 million. Total deferred revenue amount to EUR 30.1 million as compared to EUR 27.8 million as of December 31, 2018. Of the EUR 30 -- EUR 30.1 million, EUR 24.8 million were related to annual software sales and maintenance contract versus EUR 22.6 million as of December 31, 2018.

On July 1, we chose the second tranche of EUR 25 million from our credit facility with European Investment Bank. At that moment, on the July 1, 2019, our cash position increased on a pro forma basis to EUR 133.9 million. Per definition, also the debt increased by the same amount, but as first principal repayments only start in 2022 ending in 2027, the structure of this loan further strengthens our balance sheet, allowing us to accelerate the pace at which we can advance our strategy through selective acquisitions, joint ventures and collaborations.

With that overview, I'll turn the call back to Peter.

Peter E. Leys - *Materialise NV - Executive Chairman*

Thank you, Johan. As indicated earlier, I wanted to conclude our prepared remarks this morning by touching briefly on our financial guidance. While our Medical segment continues to perform very well and our manufacturing segment also performs relatively well, given the macroeconomic circumstances, our Materialise software sales have been below our expectations in the first and second quarter of this year.

There are several reasons for the softer performance of our Software segment in the first half of this year. Over this period, there have been less new system sales than were generally expected. Users of multiple machines were more cautious about adding new operators, and a number of transactions that we expected to close in the first half of the year were pushed out to a later date.

Based on the information we currently have, we expect that in the second half of 2019, our Medical and Manufacturing segments will continue to perform well and that our Software segment will perform significantly better. However, this performance will not fully compensate for the shortfall of the first 2 quarters. Still, from a revenue and deferred revenue perspective, we are comfortable today that on an organic basis, we will end the year within the guided ranges of revenues between EUR 196 million and EUR 204 million and of additional deferred revenues from software annuals and maintenance between EUR 2 million and EUR 4 million. Because our Software segment has been the biggest contributor to our EBITDA, the softer performance of Materialise Software for the first half of the year impacts our outlook for consolidated adjusted EBITDA. As a result, on an organic basis, we currently expect to end the year at the bottom of the guided range of EUR 29 million to EUR 33 million.

We could compensate for the lower contribution to our EBITDA by Materialise Software by slowing down certain initiatives that are currently running within Materialise Medical or by reducing our investment in other areas, such as eyewear or footwear. We will not do that. On the contrary, we will continue to push these initiatives forward as fast as we reasonably can, thus putting the cash on our balance sheet to work. Our continued commitment to increase our presence in promising verticals of 3D printing means that we do not only invest in internal but also in external engines for growth. The acquisition of Engimplan perfectly fits that strategy, as Fried explained earlier.

In the case at hand, because of the particular financial profile of Engimplan, this investment is immediately accretive to our revenues, Adjusted EBITDA and net profit. Engimplan had revenues of EUR 6.2 million, an EBITDA of EUR 2.4 million Euro and net profit of EUR 2.1 million in 2018, based on Brazilian GAAP and on the average EUR/BRL conversion rate of the ECB for the month of July. The transaction is expected to close still this week; all shares, both new and existing, that we acquire will be fully paid in cash, at closing. We will consolidate Engimplan's results as of August 1, 2019. The expected contribution from Engimplan obviously further strengthens our confidence to maintain our revenue guidance for the full year and also gives us some additional comfort to maintain our adjusted EBITDA guidance.

This concludes our prepared remarks. Operator, we're now ready to open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We have your first question coming from Troy Jensen with Piper Jaffray.

Troy Donavon Jensen - Piper Jaffray Companies, Research Division - MD and Senior Research Analyst

Congrats on good results here in a tough environment. So how about, first of all, the Software weakness. I get the OEMs were weak. We had picked that up, too, but can you just touch a little bit about the margins, the EBITDA margins in this segment? It seems like, historically, you guys have been closer to a 30% level or higher than that, even up or revenue levels in the segment? So just any comments there would be helpful.

Peter E. Leys - Materialise NV - Executive Chairman

Yes. Troy, if you look at the numbers more carefully, you'll see that we've continued our investments, first and foremost in sales and marketing, within the software segment; and second, we've also continued to push a number of R&D initiatives. And it's the -- I mean, the mismatch, if you want, between the continued growth of our investments in R&D and sales and marketing on the other hand, and basically flat sales that we encountered in the second quarter, that basically resulted in the decrease of our EBITDA from -- above 30% to 22.1%. And then the increased efforts in sales and marketing, I mean, it improves our continued belief in our Software suite and our continued belief that we're very well poised to continue to grab market share in this difficult market environment. But on the short term, obviously, the impact, again, is pretty significant.

Troy Donavon Jensen - Piper Jaffray Companies, Research Division - MD and Senior Research Analyst

Okay. How about to just on health care? That's been a great little segment for you guys. Could you just touch on, like, knees within that? And I'm assuming a lot of the growth is coming from new applications in CMF, but how is the knee segment?



Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Well, it's performing -- the knee guys are performing on a kind of continuous basis. The amount of cases we handle at this moment is approximately at the same level as last year. So the growth is, yes, really in CMF, but also in the field of the implants we sell directly, for instance, the aMace implant for hip surgery, but the knee guys are flat.

Troy Donavon Jensen - *Piper Jaffray Companies, Research Division - MD and Senior Research Analyst*

Okay. All right. How about then -- just last question for me. Just manufacturing did really well. And I know you guys have been kind of hit with European automotive weakness. So just curious to dive into that signal a little bit? And your thoughts on, is auto bottoming here? Can we get better growth from that vertical going forward?

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

As you correctly state, Troy, we were always worried about the situation in the automotive market and our worries are not over yet. Actually, the numbers hide a very good performance of our certified manufacturing business that has shown a growth of close to 30% over Q2, and it's obvious that it compensates for quite some loss in the automotive sector, which, personally reminds me of the years 2008 or 2009, when the situation in the automotive sector was even more dramatic than today. But nevertheless, we see a bad situation in the automotive sector.

Operator

We have your next question coming from the line of Weston Twigg with KeyBanc.

Jason Vincent Celino - *KeyBanc Capital Markets Inc., Research Division - Associate*

This is Jason going on for Wes today. One thing we wanted to ask was, with the FDA clearance of the cardiovascular planning suite, what has been early customer feedback you've been since that approval?

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Well, yes, the customer feedback is extremely positive. We are releasing this product as was indicated on the basis of a patented collaboration with Henry Ford Health Center from Detroit that is really delivering a unique planning methodology that is giving us

(technical difficulty)

better result than competition. And this is one of the new products that will enable further growth in our Medical segment. Please be aware that -- yes, we -- our medical segment has grown to a considerable size, and that a new starting product line starts from 0. So before it [adds] (corrected by company after the call) significantly to the top line, it takes some time.

Jason Vincent Celino - *KeyBanc Capital Markets Inc., Research Division - Associate*

And I think when you're giving the Engimplan contribution and guidance, it broke up a little bit. Could you maybe just state what those were again?

Peter E. Leys - *Materialise NV - Executive Chairman*

Yes. So Engimplan, Jason, the 2000 -- I gave the 2018 numbers, which is revenues of EUR 6.2 million and EBITDA of EUR 2.4 million. We expect the Engimplan business to grow somewhere high-single digit, low-double digits in 2019, and we will consolidate those numbers as of August 1, 2019.



Operator

(Operator Instructions)

Your next question comes from the line of Gregory Ramirez with Bryan Garnier.

Gregory K. Ramirez - *Bryan Garnier & Co Ltd, Research Division - Analyst*

I will just come back to the software business because -- in fact, I know if it's true or false, but the line was very bad when you made the comment. So could you just repeat your comments regarding the prospect of this business for H2? You mentioned that there were some deferrals, but what is your level of confidence that the transactions that you are expected in Q1 and Q2 will close in H2?

Peter E. Leys - *Materialise NV - Executive Chairman*

Yes. Well, thank you, Gregory, and my apologies for the line not being as clear as it should be. As I explained during the prepared remarks, our level of confidence is such that even without the contribution of Engimplan, the performance of Software in the second half of the year should be such that we should still be able to reach the bottom of the overall consolidated EBITDA guided range between EUR 29 million and EUR 33 million. So that implies that Software will perform significantly better in the second half of the year as compared to the first half of the year. Amongst others, because we do expect that the number of deals that were missed in the first half of the year will slip into the second half of the year.

Gregory K. Ramirez - *Bryan Garnier & Co Ltd, Research Division - Analyst*

And it would be more Q3 or Q4? Because last year, your Software revenues were down, but there was a different seasonality compared to 2017. And this time, do you expect a more pronounced seasonality?

Peter E. Leys - *Materialise NV - Executive Chairman*

We -- frankly, we expect, as always, but probably even more outspoken this year than the years before, we expect a very strong last quarter of the year.

Johan Albrecht - *Materialise NV - Executive VP & CFO*

Especially, also that last year, in Q3, we already had an increase of 17% compared to the year before.

Gregory K. Ramirez - *Bryan Garnier & Co Ltd, Research Division - Analyst*

Yes, sure. So do we have to expect some revenue decline in Software division for Q3 this year?

Peter E. Leys - *Materialise NV - Executive Chairman*

Well, I mean, we have to -- I mean, if we have to do significantly better in the second half of the year than in the first half, then Q3 should be better -- should be stronger quarter already, with an even stronger Q4.



Operator

And I am showing no further questions at this time. I would now like to turn the conference back to Mr. Peter Leys.

Peter E. Leys - *Materialise NV - Executive Chairman*

Thank you so much. And thank you all for joining us today for this second quarter call. Johan, by the way, will be in the U.S.. Johan will be attending the KeyBanc Financial Conference in the course of next week. And obviously, we look forward to meeting some of you at that conference or during any of the other conferences that we intend to attend in the second half of 2019. Thank you all for your time, and we look forward to continuing the dialogue.

Johan Albrecht - *Materialise NV - Executive VP & CFO*

Thank you.

Wilfried Vancraen - *Materialise NV - Founder, CEO & Director*

Thank you.

Operator

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

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