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COH.AX - Half Year 2020 Cochlear Ltd Earnings Presentation

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PRESENTATION

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Okay. Good morning, and thank you for joining the Cochlear results. For those of you online, I'm Dig Howitt, CEO. And what we'll do, I'll talk through result at high level, and then Brent will give more detail on the financials, and I'll come back with the -- to recap on the outlook, and just to reinforce that our strategy is unchanged. So let's get underway.

So the headline of this result is the Cochlear implant unit growth up 13%. I'll talk a bit about that, as we saw growth across developed markets and emerging markets. And on the back of the Profile Plus launch, it's very good to see that we are clearly regaining market share in key markets, and I'll talk more to that.

Our Services revenue is up 5%. So again, we're getting a bit later in the cycle. With Nucleus 7, we're cycling high comps. So we're expecting, and we are seeing slower growth, but we continue to see some growth there. And Acoustics was below our expectations in the half with the decline in Acoustic sales, and I'll talk about that particularly in the context of the Osia approval and launch in the U.S. and our overall outlook for Acoustics, which I think is very, very favorable over the medium term.

We've continued to invest both in R&D and in our sales and marketing programs. So investing to retain our market leadership and to make sure that we are trying to drive growth, particularly in the adults and seniors segment in developed markets and in supporting more children through the emerging market.

From an overall profit perspective, you saw our profit, underlying profit was in line with last year. That was a little bit below where we expected due to the lower Acoustic sales, but also, we are cycling a strong first half in '19. And you saw this pretty significant impact from our hedging program, which obviously starts to roll off through the second half and into next year. And Brent will talk more in detail about the P&L and the cash generation.



Turn to Cochlear implants, so there, certainly pleased with what we saw there, with a 7% growth in developed markets. The U.S., up over 10%. So we think we've regained all of the share that we lost to -- because we're not having a 3.0 Tesla product last year. So it's good to see that. In Europe, we've grown 5% in the half. And in Europe, we rolled the Profile Plus out over that half. So Europe, you have CE Mark. And then some countries, you can sell straight away, and others, you need to get registration, which can be delayed 6 months or so on approval. So we now have the Profile Plus out through Western Europe. We've seen that growth of 5%, and that growth was more in the second quarter than the first quarter. So confident we're regaining share in Western Europe.

We continued to invest in market growth in the U.S., and we've talked extensively about our programs that we have in the U.S., and we're also moving those programs and from the learnings of those programs into Europe. Europe is more constrained because of funding caps or tighter indications. So the market access element of our growth programs is very, very important in Europe in terms of unlocking the capacity to grow. In the last year, 12 months, we saw 2 important changes: the U.K., expanding indications and Belgium expanding indications just in August. Both of those effectively double the addressable market. And then what we expect to see is that doubling doesn't happen overnight. It takes a number of years for those new indications to result in referrals and growth in the underlying CI market.

In Japan, where that change was now coming up to 2.5 years ago. We continued to see strong growth in the half in Japan on the back of these new indications. And we've also just launched the Slim Modiolar Electrode in Japan. So again, that just shows that sometimes these implants, and electrodes takes some time to roll out with regulatory approvals, but excited by the opportunity with Slim Modiolar everywhere around the world. And I'll talk more about that, but with the Japan launch, we're so excited with what we can see there.

Emerging markets was very strong. Over time, that emerging market sales are not consistent, but there is absolutely strong growth potential across all of these markets. We have been investing over the last 5 years in expanding our presence in key markets. And in the half, we saw strong growth in the Middle East, where we've been building out our presence and also a very strong growth in Greater China in the half on the back of an expanded presence. I'll talk more about the coronavirus a little later, but obviously, it's -- one of the disappointing things is the coronavirus, and there are many areas that we have such great momentum coming out of last half into China and are now seeing virtually no surgeries at the moment, but I'll give more of an update on that a little later. But our investments in emerging market are clearly paying off when we look at the long run trend that we're seeing, albeit that there will be ups and downs over time in the sales there. So that's Cochlear implants. Very important, we delivered on that. And I think we do really do have a very, very strong product portfolio now with more exciting things to come.

Services. So we're getting later in the cycle for -- with Nucleus 7. Penetration rates are good, particularly across the developed markets. We continue to see growth. And you can see from that chart there that we've had very strong growth in Services over the last few years on the back of first Kanso launch and then the Nucleus 7 launch. We're getting later in the cycle for both of those. And therefore, we're seeing a tailing off of that growth. We still expect to grow, but we're seeing that growth tailor off. And we continue to invest in engagement and engaging our customers so that they get the best experience that they can. And it also helps us into the future we think with getting people the best technology and therefore upgrade penetration in Services revenue. So Cochlear Family membership continues to grow, up 30% over the past 12 months and now more than 160,000 members. We continue to build out that program around the world.

On to Acoustics, and I think this is quite important, albeit Acoustics is 11% of our overall revenue, we did see a reduction in sales in the half. We expect that to continue into the second half. And there's really 2 reasons for that. We've definitely lost some share, both to competitor launches, but we think a significant factor here, and we see this, is that surgeons are holding patients back in anticipation of the Osia approval. So we did receive Osia approval from the FDA. We have gone to a full market launch in early this calendar year in the U.S. So we're now rolling out, but we won't see approval in Europe until late in '21, and that's because we'll be getting that -- seeking that approval under the new EU MDR regulation, which starts from May in this year.

So we just had a look at the Osia product, because there's really some important features of this product as to why we're really very confident of the Acoustics category growing over time. And if you saw on that last chart, you see our Acoustics sales over the last 3 years, they've been flat. And what we've seen over time with Acoustics is that we see some growth with new products, but we really -- and share swings on new products, but we're not seeing a significant underlying market growth, despite there being a very significant clinical need. And we think part of that is that while people get really good outcomes with our Baha system, it can be a harder product to sell for a surgeon and often hard for a consumer from a cosmetic perspective.



But if you look at the Osia picture shown here, there's a couple of important features of the Osia product. The first one is that the surgery is simple and easy as Baha is. So surgery is quick and quite simple. The second one is the externals there, so you can see the external is slim. It sits against the head rather than a bit further than the head from Baha, so cosmetically, it's a much more appealing product than Baha. And it also has all of the streaming capability with iPhones that our broader product portfolio has. And perhaps most importantly is the outcomes, is the performance of the product. With the technology in the Osia system, a piezoelectric stimulator, we've been able to deliver really high gains at high frequencies. And it's high frequencies that actually deliver the quality of sound and the quality of hearing. And that's the single biggest bit of feedback we've had from customers who are now wearing the Osia, have the Osia product and wearing the external, is how good the high-frequency responses and how natural the sound is. So we've had terrific feedback from surgeons and from customers. We've had customers in tears on switch on, which hasn't really happened before from an Acoustic perspective. So we're very confident of the long term, the medium-term outlook for this product, that we've now got to get regulatory approval across a whole range of markets. In some markets, we'll also need to follow-up with reimbursement because Osia Baha might be reimbursed, but Osia won't be, and Osia will come in at typically a higher price point than Baha. So it will take some time for a full global rollout, but we really do think that this can drive significant growth in the Acoustics category over time. And therefore, it's been worth a significant investment to get it to market even if we see a shorter run dip in our Acoustic sales as we put our efforts into getting Osia launched.

On to the CI portfolio. I said we are clearly regaining market share across developed markets, and we've been doing that by having the Profile Plus implant rolled out. We continue to see very strong results and growing evidence of the performance of the Slim Modiolar Electrode that we have on both the Profile and the Profile Plus Series of implant. But we're seeing there is very, very consistent placement in the Cochlear placement close to the modiolus, the hearing nerve. We are seeing that delivering very good hearing outcomes. And we're also seeing some data emerging on hearing preservation with the Slim Modiolar Electrode. So we've been working on perimodiolar electrodes now for 20 years, more than 20 years. We believe it is the right technology to give the best hearing outcomes, and what we're seeing with the Slim Modiolar is clinical evidence coming to back that belief and that hypothesis that we've been investing in for many years.

We have reached the end. We also have a straight portfolio of electrodes. And we do that because we know that there are different surgeon preferences and that there are people, surgeons who prefer a straight and a lateral wall electrode. At the end of last week, we received FDA approval for the Slim 20 Electrode. So this is a thin, flexible electrode. It is designed for hearing preservation. We don't know if we get hearing preservation till we run the trials, until there are studies that show the results. But certainly, that's been the design intent, is to have low trauma on insertion with a goal of preserving residual hearing. So it builds out our portfolio. And I think when you look at this implant and electrode portfolio, combine that with Nucleus 7, which is the smallest and the only processor on the market with streaming to iPhone and Android, I think we very clearly have the strongest portfolio, backed by our customer service offering. We push a very strong competitive position, which is really a great place for us to be looking at how do we grow the market with confidence of our competitive position. And obviously, that market growth is a big part of our focus.

So just finally, before I hand over to Brent, a quick regional review.

So you see our 3 regions here. So a 3% constant currency growth in the Americas. That was on the back of, as I said, greater than 10% Cochlear implant growth, so very strong CI growth. Weaker Acoustics and Services relative to last year. We saw some good growth in Services also in Latin America in the half.

In EMEA, again, strong CI growth. In Western Europe, similar pattern to the U.S., strong CI growth, a decline in Acoustics and less growth in Services. A very strong growth in the Middle East, which, as I said, was terrific to see. And then in Asia Pacific, actually, really good growth. In Asia Pacific, we're seeing growth across a whole range of markets, so important developed markets. Japan and Korea grew strongly from a CI perspective in the half. I'm very pleased to see that. As I said, very strong growth in China across that half as well. But the investment we've been making in Asia Pacific are showing in the revenue that we are generating.

And with that, I'll hand over to Brent to talk through some of the financial detail.



Brent Andrew Cubis - Cochlear Limited - CFO

Thanks, Dig. Hi, everyone. Okay.

Dig spoke about the sales. I'm not going to talk on the sales review. I'll touch more on the detailed P&L.

I think the thing to really think about, too, in terms of our investment to drive market growth. If you look at our P&L, obviously, R&D is more long term and our sales and marketing is mainly short term, but there's a lot of initiatives we've done in recent years which is more medium to long term than sales and marketing. We talk about market access here and the standard of care, which is your John Hopkins University, and the study and so forth. Big investment in CPN. But other things which should -- are not here, which is really paying dividends and the good results we're seeing in the Americas is because of a lot of initiatives which aren't actually listed here. So small things, but they all count. And it's things like using technology, [Showpad,] SignHEAR, which is like the DocuSign thing, which takes 2 weeks out as the typical time -- turnaround time for approval for a Cochlear implant from the surgeon to the recipient. [Showpad] enables the salespeople to get out on the road a lot more and actually spend more time with customers. Cochlear Link, we've invested in that great deal. And that's working really well to get far more information and data. So it's -- the key there is getting better data, which helps us with servicing our recipients and providing far better service to our customers. And we've invested heavily in recipient services as well. So I think it's important when you look at the P&L, you think sales and marketing has also got much more of a mix of medium term than it used to in the past.

We have a very strong balance sheet still, and you can see that. When you look at our debt increase, it's only about \$40 million or so. I'd like to think of that as really funding the hard, longer-term type of assets in terms of the Denver fit out and the China plant. So OpEx, our operating cash flow is still funding our normal kind of CapEx. And the debt is only increasing for our long-term appreciation CapEx, like the China plant and Denver. Dig will talk a little bit more about the outlook at the end.

And obviously, you saw the innovation fund update last week. Overall, the total investments in the innovation fund have probably doubled in value over the last 5 years, if you look at that way. Okay.

In terms of the P&L, you can see here the reported column there in the middle, in Aussie dollars and in constant currency on the right. That difference there, the 4 points in the sales revenue is that 5% change really in the U.S. dollar, a little bit in the euro and about 3 percentage points in the pound. I think the highlight here, a couple of highlights, I want to point out the gross margin. On the surface, it looks flat. But the big thing here is, as Dig mentioned, the increase in our weighting towards the emerging market and the pressure that's put on our average selling price, we're still able to have a gross margin, 75%. I think that's a really good outcome. Also, last year, we had more weighting towards processes and Acoustics, which have a higher margin. So all of that, we've managed to keep the margin at the same level, which I think is good. Part of that is because we haven't had to take up as much in our warranty provision as we have in the past because we have 3 to 4 years' worth of data now on the N7. And it's much more reliable than the previous generations, which means we haven't had to take as much warranty in the past. So that helps as well. We've called that out in the last couple of years. The better design of N7 and the more reliability has really helped the margin.

If you go down to sales and marketing, in that, I mentioned before some of those initiatives which we're doing out in the field. And there's probably about 30, 40 more people in the field compared to a year ago and more in our markets where we've gone direct. The other thing in there, which wasn't there a year ago is the Brexit. There's a one-off cost there, which is not cheap. But we had to do that with the move from U.K. to Germany for our European business and setting up Oracle, making sure that we could do our billing runs for our customers and things like that. And that's no small piece of work. It's about a year program. And as Dig mentioned before, some of the investment in the go direct markets which are going really well. We only started those halfway through '19, so they weren't there in the first half a year ago.

R&D, there, you can see that's more or less in line with -- it's still staying at 12%. There's only 1 percentage point difference there with the constant currency that shows the weighting towards Australia, which, again, is the reason why we've got to have those FX contracts, which we'll touch on now.

Other income had the cycle earn-out as well. It's a little bit lower than last year because we had a little bit of extra income, other income last year.

On the FX contracts, the big difference there compared to a year ago, the spot rate and the contracts last year was about \$0.03 to \$0.04. This year, it's more like \$0.07, and we've got more revenue. So that's the main reason for that jump. Those contracts were taken out 18 months to even a bit longer ago when the dollar was around 75, 76. But that, as Dig mentioned, will fall off in the second half, and we'll get a benefit of that in the second half.

Going down to the net finance cost, that includes about \$2.5 million for the lease adjustment. So if you looked at just the bank interest, it's actually fallen compared to a year ago given that debt has gone up by about \$40 million. I think that's a good result. Our weighted average interest cost has dropped from 2.5% to 2.1%. But most of that increase -- most of that saving in interest, bank interest, is because of our tight management of our cash flow. So I'm happy about that.

The effective tax rate stays about the same. And you can see the impact there of the higher growth in sales and marketing versus our growth in revenue on our margin. At the end of the day, we're not going to take the foot off the pedal with our initiatives, which is driving growth. We still got enough confidence to continue to spend in that area, which we continue to do in the first half to make sure we're driving it going forward. And you saw the impact of the revaluation of the announcement the other day, and that's come through at the bottom there. Okay.

In terms of the cash flow, it's -- the overall -- now if you go down to operating cash flow as a percentage of our net profit, it's pretty close to 100% still, which is good in anyone's language. It's not as high as it has been in the past. That is partly because we had to pay out a lot of creditors which had built up in June last year for the inventory buildup we saw for CI600. But overall, I'm really happy where our debt is and so forth, which you see on the next page. And we've done a good job there.

If you look at the depreciation line there, there's 6 months increase there, that \$4 million or so. If you annualize that, it's probably about \$10 million because you're going to have a bit more of a ramp-up in the second half. So remember, we've been outlining in the last couple of years our increase in CapEx. We're starting to see the impact of that in our D&A line coming through now.

I've already touched on the net interest expense.

The income tax payable. Last year, we had a few refunds coming towards the end of the year, which helped a little bit. But also in terms of this year, you actually have to pay on installments, which is based on what the tax office dictates to us on our income because we spent a little bit more across to the Europe for the Brexit emergency stock that did impact our revenue, which is how we had to pay our tax. So there's a little bit of a timing around that as well.

As I mentioned, our CapEx has gone up mainly because of China and Denver. And then you can see that in our debt -- in the debt summary and how much we've actually drawn down on our facility. And some minor things in terms of intangibles, that's mainly to do with our IT and digital investments and so forth.

So in terms of the balance sheet, as I mentioned, very happy where our debt is despite our improvement in sales, we've managed to bring it down, which I think is good in anyone's language. Inventory has gone up because of that Brexit emergency stock and a bit of a switchover from CI500 to CI600 and a little bit of buildup for Osia as well towards the end of the year as we're going to sell in America. And I mentioned before, the impact of the -- paying out those creditors impacted our cash flow on the previous slide. So that's where that's come down there, which has contributed to the increase in our working capital.

Property, plant and equipment, China, Denver, investments, that's Nyxoah, and the other net liabilities, that's the impact of some of those provisions. The Sycle earnout coming out, the tax we paid, the impact of these FX contracts, which you can see coming through, it's about \$20 million there or so, that's the mark-to-market of those FX contracts, which should come down. And also, the provision around the warranty, which I mentioned before. So all reasonable things to come through, but it's a net effect of those being released.

Dividend, as we mentioned, we've kept that now. It's 70% of the underlying profit, okay? So we've taken out the innovation fund when we're calculating our dividend, and we're showing a 3% increase there. And for the full year, we'll be -- depending on how the impact of the coronavirus goes, we'll be updating that at the time.



That's probably about it. I'll hand back to Dig now who will talk about the outlook.

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Thanks, Brent.

Just a short recap of our strategy, which I'm sure you're all familiar with, just before we get to the outlook.

So 3 strategic priorities. These are unchanged. We're retaining market leadership. And I think with the product portfolio that we have that I've talked about and the services that we offer both to customers and professionals, I think we're in a very, very strong position from an overall competitive perspective. That sets us up, as I said, to be able to really drive at trying to grow the market, and I'll talk about that when we think about our segments. But that's really critically important, as we've talked about, is getting more people from what's a -- there's a huge clinical need for hearing implants into genuine demand, people at clinics. And in doing that, we want to deliver consistent revenue and earnings growth over time.

We also think about the market in terms of 3 segments. So the adults and seniors market, we've talked about a lot. That's the biggest opportunity in developed markets, the opportunity there to increase penetration. We continue to invest in our programs around market access, around direct-to-consumer and around building a referral channel from hearing aids through -- to Cochlear implant. And in the longer run, working towards standard of care and making Cochlear implants a standard of care for people with severe to profound hearing loss. So we have those 4 programs. We are rolling them out through the developed world. We continue to see good progress, particularly in the U.S., where we are most advanced in terms of the numbers of people that we're able to influence on their journey towards getting the right hearing solution for them.

Children in developed markets, this is a very important segment, both in terms of the quality of life, clearly, for the quality of life for children in terms of realizing our mission. And it also has a long run economic value from -- both from the child's perspective but also from a company perspective with the upgrades through a lifetime. This segment of the market is flat. So both rates are typically flat or even declining in developed markets, so we don't see growth in children developed. We do see some opportunity to gain share, but there's not a significant opportunity to grow the market. And then children in emerging markets where -- which I've talked to about significant opportunity over time, and we're working hard there with our presence to expand funding, to expand surgical and audiological capability and to really build awareness across a whole range of markets. And we're seeing our investments there continuing to pay off from an emerging market perspective.

So if we look at our investment priorities, it really is about investing to grow, making sure that we do build awareness. As I said, these are long run programs and we see that particularly in market access, when we look at Western Europe, and it's great to see the improvements in the U.K. and in Belgium. They've taken a number of years of effort work to get there. There are more countries in Western Europe where we want to see those changes as well as investing in our awareness progress, both for consumer and for hearing professionals. They are aware of the full range of hearing solutions.

We want to continue to deliver operational improvements, so that we can fund these growth activities and continue to fund as much as we can. So we've done a lot on the gross margin over the last several years. We can -- there is more we can do and will do across the business to keep driving efficiency gains, so we can redirect funds towards our -- either retaining market leadership or driving growth.

And we want to keep -- make sure we keep a strong financial position. We do have good cash flow. We want to keep it conservatively geared, the balance sheet, and we want to continue to target a dividend payout of 70% of our underlying net profit.

So all of those priorities continue and support the work that we're doing right around the world.

The growth by segments, really -- we've really talked through each of these. Cochlear implants, very -- the biggest part of our business, very important, and you saw in the half going well. We expect to continue into the second half. Services, lots of opportunity there as the base grows to drive the growth in Services to increase penetration. And something we've been working more at is expanding funding in emerging markets for Services, and that's a long -- again, a long journey, but we've started to see a few improvements in funding for Services in some emerging markets,



which is important over the long run. And Acoustics, already talked about Osia. The potential for Osia to fill what we see is a very, very significant clinical need with a product that is very effective, surgically simple and cosmetically attractive, we think, really creates a great long run opportunity to build out the Acoustics segment. So they are the 3 revenue areas that we always are driving towards.

And finally, if we look out to our guidance into the second half. So we did bring our guidance down from \$290 million to \$300 million, to \$270 million to \$290 million, as you saw on the back of the coronavirus. And so we obviously are monitoring this very closely. There's a lot of uncertainty as to how this will pan out. At the moment, we are assuming that the impact of the coronavirus is contained to Mainland China. We continue to see that surgeries are being deferred or not scheduled across Mainland China.

From a supply chain perspective, our suppliers have restarted production, but they have restarted at lower -- not many of them are not yet at full capacity, but certainly, we're encouraged, and we do have 3 months of inventory. They are back in production.

So we -- overall for our outlook for the half, continue to see strong growth in Cochlear implants, particularly in developed worlds. Obviously, emerging is much less certain given the significance of China to our emerging market sales.

Services, we expect to see growth, but that growth, as I said, will tailor off as we get later in the cycle. Acoustics, we expect a very good ramp up of Acoustics in the U.S., but still overall, Acoustic sales to decline across the year.

FX contract, as Brent has said, that rolls off. So there's about a \$10 million gain in the second half from those contracts starting to roll off on the lower rate contracts coming through.

And our CapEx, as we've foreshadowed, CapEx and investment expenditure, both on the China factory, Denver office and CapEx across the business, to peak this year at about \$180 million and then roll off going forward. And obviously, that increase in CapEx has an impact on our depreciation as we look into the future.

And so I think we will stop there and go over to questions.

QUESTIONS AND ANSWERS

Andrew Goodsall - *MST Marquee - Healthcare analyst*

It's Andrew Goodsall from MST. Just first question. You flagged a strong sort of recovery in growth in the second half sales. And I'm just wondering sort of that's based on, whether you've got visibility on contracts or you're taking a bullish view on the U.S. market.

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

So it's a few things. So we certainly see the share that we have regained and are regaining, and we would expect that to continue into the second half as well as there's some underlying market growth. And we're also cycling a pretty -- a lower comp in the second half last year, where we started to see the impact of share loss. So share gains, lower comp and some market growth all driving developed market growth into the second half.

Andrew Goodsall - *MST Marquee - Healthcare analyst*

Okay. But you -- I guess you've sort of -- well, you're at February now, so you're sort of feeling good visibility on in making that call?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Yes. Yes. Look, there's always uncertainty over any forecast you make unless it's a -- and we even look -- even tenders can move around. We've seen that over time. But from what -- certainly, what we're seeing, we're confident of our outlook on the CI growth for the second half.

Andrew Goodsall - MST Marquee - Healthcare analyst

Okay. And just the weaker Services. Obviously, it's in line with sort of where we are in the cycle of launches. I guess just trying to -- I know you're not going to call out launches. But I guess in the normal sequence of events, we would expect over the next couple of years, you'll be in the market with an updated product that will, I guess, reinvigorate the upgrade cycle again.

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Yes. Yes. So as I said, so I won't talk specifically about launch timing, but there is certainly more that we can do from an external technology perspective, and we will continue to update our externals at regular intervals basically off-the-ear and the behind-the-ear processors are both clearly important parts of our portfolio, and those sorts of things do drive growth in Services as they're launched.

So I think we're now going to people on the phone.

Operator

(Operator Instructions) Your first question comes from David Low of JPMorgan.

David A. Low - JP Morgan Chase & Co, Research Division - Research Analyst

Just a question on market growth. We did hear some commentary that the market growth had slowed and it was difficult to distinguish that from Cochlear's own issues with a sort of less competitive product a year or so ago. Just wondering if you could comment on what you think market growth's done perhaps over the last 6 months and over the rest of the year?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Yes. And I think, David, the other way to talk about that is to talk about it by segment rather than an absolute number overall because it is actually in the segments what that -- are the drivers of growth. So I said, look, in children, there really isn't market growth or there isn't market growth. Both rates are flat. The incidence of hearing loss is flat. So then when you look at growth in an individual developed country in the first instance, you got to look at what's the share of children, because that part might grow, and then what's the share of adults and seniors. So we do -- and we do continue to see growth in adults and seniors, and we've seen that particularly in the U.S. on the back of our programs over several years. And in the U.S., for example, we have 75% of the surgeries are adults and seniors, 25% children. So therefore, we see a faster rate of growth in the U.S. than we do in Western Europe, where 50% of the surgeries are in children and 50% in adults. And I think if you overlay in Western Europe the constraints on either indications or funding gaps, growth in adults and seniors, it's harder to get in Western Europe than it is in the U.S. So that's sort of looking at developed markets. So I'm not going to give you a single number because there really isn't a single number than we are seeing growth, but that growth is strongest in the U.S., a bit weaker in Western Europe from a developed market perspective. Seeing good growth in Japan on the back of the indications. And also, in Korea, we're seeing some growth there as awareness is building out. And both of those are particularly sort of career driven by adults in Japan, as we've talked about for many years, we actually use an opportunity to grow in children, and we have seen growth in children in the last half in Japan, but it's one of the few markets with the -- developed markets with that opportunity.



And look, in emerging markets, it's almost impossible to put a number on. The -- I think the best proxy for that would be to sort of go and look at -- for us to look at our emerging market sales over time. And the underlying growth rate there is certainly above 10%, but there is pretty significant variability year-on-year.

David A. Low - *JP Morgan Chase & Co, Research Division - Research Analyst*

Just a follow-up on that. I mean I see the commentary on Europe being constrained by indications and reimbursement, and then we're hearing that as a very common refrain in this sort of presentation. Can we -- is still that down? I mean is the U.S. a natural growth rate where you saw 10% again and Europe is more likely to come in at half those growth rates?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

We haven't -- I think, certainly, lower growth in Europe, and there's 2 factors here. So one is the children bit. So if you work out, you've got 75% of the U.S. market growing and 50% of the Europe market growing, if you look at adults. Therefore, you'd expect, just on that basis, a 50% higher growth rate in the U.S. than you would in Europe. And then in Europe, that -- getting that growth is harder because of the constraints. So you suggested twice the growth rate in the U.S. to Europe. It's probably somewhere between 50% and double, that probably between what you said and what I said is the difference in growth rates between the U.S. and Europe.

David A. Low - *JP Morgan Chase & Co, Research Division - Research Analyst*

Okay. No, that's helpful. Look, one last question then. Just coronavirus, do you think you'll be likely to be updating us through the period? Or is this something we're waiting for August to know?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Look, I certainly hope that we can update through the period. I mean for us to update, something needs to change. And I certainly hope that something does change and we can give an indication of surgeries restarting. But at this stage, we're -- it's still very early, days after lunar new year. We're not in a position to do that yet, but I'd hope that we could do.

Operator

Your next question comes from Sean Laaman of Morgan Stanley.

Sean M. Laaman - *Morgan Stanley, Research Division - Australian Healthcare Analyst*

Just looking at -- now the N7 upgrade cycle is maturing or slowing, however you want to phrase that. I mean if you look back on our past upgrade cycles, how does this one compare in terms of penetration? And with ongoing initiatives, where could the N8 get to? Will it be materially better or in and around where the N7 has achieved?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Okay. So the -- I said before, the biggest part of our Services growth is just -- is the size of the customer base. So that's the biggest factor in looking at how big each generation can get. The second one is penetration. What we're seeing on penetration for Nucleus 7 is it's broadly similar to Nucleus 6, I think. In some countries, we are a bit ahead of where we were in Nucleus 6. In some countries, we're a bit behind. There's a range of factors that influence that. Certainly, our work to try to increase engagement is an important factor, but then we can come up against other constraints like clinic capacity, like funding constraints. So it's sort of a complex formula.



But overall, we're probably -- our penetration so far in Nucleus 7 is pretty similar to where we were in Nucleus 6 at the same time.

Sean M. Laaman - *Morgan Stanley, Research Division - Australian Healthcare Analyst*

Sure. And I might have missed this, but was there any lumpiness, for want of a better term, in that 20% number in emerging markets unit growth?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

So certainly, there were very different growth rates across our -- the different emerging market countries. To get a number above 20%, we need pretty good growth across a range of countries, which we did get. But in the mix there, there's countries that were at 0 and countries that are way over 20%, and that's pretty typical on emerging markets.

Operator

Your next question comes from Saul Hadassin of UBS.

Saul Hadassin - *UBS Investment Bank, Research Division - Executive Director & Research Analyst*

Dig, just comment if you can give us an update on the cycle acquisition? Just noted in another release there through the P&L. Just your thoughts on non-integration of that business and whether it's leading to referrals vis-à-vis the cochlear implant side of things, that would be great.

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Yes. Okay. So look, cycle is -- we're very happy with where the business is at. It hasn't grown at the rate -- the growth that was there in cycle over the last few years has slowed a bit in the last year, but that's okay as -- in a competitive market. The key thing for us for cycle is that we are learning about the hearing aid channel, which is the developed markets where the majority of our future potential customers are, and that we can use cycle and our own people to help influence and educate that channel on the effectiveness of cochlear implants. So we've made some good progress in doing that. We've made some good progress with the cycle's software to be in a position to be able to flag potential candidates for cochlear implants for clinics. So certainly, very pleased with what we're learning.

We are seeing an increasing number of referrals from the hearing aid channel to cochlear implant centers in the U.S., albeit it's still a small part of our total sales, but it's certainly growing at a very good rate. And what we're seeing is that the number of people, and also seniors, that we are in contact with in some way before they get an implant is increasing. And that's important. And whether that's they come to our website or attend an awareness seminar or something like that, that's important because that's how we build out awareness in consumers.

And it's also -- we see our cochlear provider network in the U.S. important because in many -- for many of those centers, when they refer someone on for cochlear implant, they then see that person after the surgery, do some of the mapping and programming afterward, and they see how well they are doing compared to how they were doing with a high-powered hearing aid before the surgery. So the best evidence we can put or that can be put in front of someone are real-world examples of people hearing significantly better after they've got a cochlear implant compared to their hearing with a high-power hearing aid.

So that cycle is all part of a holistic approach that we're taking to the hearing aid channel. And we're pleased with what we're seeing in that so far, knowing there's still a long way to go.

So Brent?



Brent Andrew Cubis - Cochlear Limited - CFO

There's only one more half as well. So for the release of that revenue, wherever that finishes this year.

Saul Hadassin - UBS Investment Bank, Research Division - Executive Director & Research Analyst

And if I just -- one more -- one other question, Dig.

Again, I think historically, the penetration of upgrades through the installed base, as process upgrades have rolled out and as cochlear has embraced measures to drive penetration higher through things like cochlear family. And I guess, we're advocating for recipients in terms of being able to get their upgrades through insurance companies. I think the expectation has been that you would actually see a high participation rate in upgrades generally. Can you talk to the N7 cycle? And do you see this as a cycle? I know you commented on this versus N6, but do you see this process or upgrade cycle as one where you will ultimately achieve a higher penetration of that installed base versus what you may have been at the end of that 5-year window for the N6 or the N5?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Yes. Look, I think we can do that. And there's a few reasons, I think, to believe that we can do, increase the penetration over time, albeit it's not easy to do.

So the first of those is that we see pretty significant differences in penetration rates across countries. And typically, what's driving that is the level of clinic engagement in wanting to get people on to the latest technology. So if a clinic is very engaged in wanting to make sure that all of their patients have the latest technology, we'll see very high penetration rates at a clinical level and when we see a number of those clinics in a country, we see higher penetration rates. So we know that engagement with the patient drives upgrades. And historically, that has mostly been done by clinics. And where that's done and done well by clinics, we don't want to get in the way, we want that to keep happening.

It's -- then in other countries where the clinics are less engaged in upgrades, and the U.S. is one of those, where we want to try to engage more directly, so that we can help make people aware of new opportunities, new technologies. We also rightly have to navigate a whole bunch of laws around privacy and promotion, and they're different in each country, and that those are there and we do that successfully. But there is, I think, very clear evidence that when people are more engaged, they're more likely to upgrade. What we're working out is where are the gaps in the engagement and how can we fill those, and the U.S. is certainly one of those opportunities, but it's also one with a number of constraints around how we can promote.

So -- and Cochlear Family is another example where we are -- it's an opportunity for us to increase engagement. However, the Cochlear Family is only about a couple -- 2 years old. So it's not until those people sort of pass through an upgrade cycle do we really see if that being a member of Cochlear Family will lead to a higher penetration of upgrades. And that's because Cochlear Family's members now typically join when they get their implant or when they've already come in for an upgrade. So it's only when they come around next time will we see does that increase penetration.

Operator

Next question comes from John Deakin-Bell of Citigroup.

John Deakin-Bell - Citigroup Inc, Research Division - Director & Head of Healthcare in Australia and New Zealand

Look, just a couple of questions on the costs side. The sales and marketing growth, I think it was 9% on a constant currency basis. How should we think about that over the next few years? Is that a similar shape given all of the work you're doing in expanding the market, regardless of kind of the short-term revenue -- the revenue line?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Certainly, the sales and marketing line is the one that we're trying to direct as much of our spending to as we can, while we continue to spend enough in the rest of the business to make sure that we're compliant and efficient.

Our spending growth will slow. It has slowed, so we did lift our spending pretty significantly on the back of sort of falling Australian dollar and the opportunity from the cycle earn-out, the gross margin expansion on the back of warranty. So we've used those things to lift sales and marketing.

Looking forward, there are less -- fewer of those opportunities to drive such a significant increase, but we're obviously working off a much bigger base. And our focus now, while we want to keep lifting that expenditure, is to make sure we're spending it very, very effectively.

Brent Andrew Cubis - Cochlear Limited - CFO

Most of that increase -- John, most that increase in sales and marketing, when you look at the segment report, and you can see it's all in the regions. And you take out the cost of sales, and that growth is all in the regions. So as Dig said, we've brought up the base here and we're investing more in the regions to grow.

John Deakin-Bell - Citigroup Inc, Research Division - Director & Head of Healthcare in Australia and New Zealand

Right. And Brent, just while I've got you there, you talked about the strength of the balance sheet. And I note in the detailed accounts, there's a segment there, about \$268 million damages that have been awarded. You're expecting an appeal in 2020. But obviously, that -- if that's upheld, that will have a reasonable impact on the balance sheet. Can you just kind of give us your sense of the timing of all of these impacts?

Brent Andrew Cubis - Cochlear Limited - CFO

So we have a hearing this year -- this half, and we're expecting the result of that in -- towards -- we're not sure, but it could be a few months away. And as the notes in the accounts outline, we actually have a facility approved in place in case of a worst-case scenario. So the low gearing there allows us to take on the extra debt if there is a unfavorable hearing result. So that's -- we're expecting that at some stage this year. When? We don't know.

John Deakin-Bell - Citigroup Inc, Research Division - Director & Head of Healthcare in Australia and New Zealand

And is that -- if it goes to worst-case scenario, the gearing goes up reasonably. Does that constrain your ability to reinvest in the business for a year or 2 while you kind of -- the cash flow works to pay down that debt?

Brent Andrew Cubis - Cochlear Limited - CFO

Do you want to answer?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Yes. So obviously, if we get a worst case, we're going to need to look very, very carefully at what we do. But from what we can see now, it shouldn't have too much of an impact on the P&L and what we invest through the P&L.

Operator

Your next question comes from David Stanton of Jefferies.

David Andrew Stanton - *Jefferies LLC, Research Division - Equity Analyst*

Firstly, I may have missed this, but how many tenders did you do in the first half in China? Usually, you do call that out.

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Okay. China -- David, China tenders, the first half, virtually none. It's a very, very small part of our China business, the national tender, and that was a very small number. So that's why we stopped calling it out, it's insignificant in our global business and increasingly insignificant in terms of our China business.

David Andrew Stanton - *Jefferies LLC, Research Division - Equity Analyst*

Fair enough. And second, can you talk me through, given that you mentioned the OSIA is going to have a higher price, any coding or reimbursement issues that you've seen, particularly in the U.S. as you already got some approval in Europe?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Yes. So we don't have approval in Europe. In the U.S., the devices are reimbursed. And we provide guidance to clinics on the codes that they can use from a hospital perspective for surgeries and operating rooms. It's certainly less clear there what specific codes that can be used, and therefore, that's part of rolling out a new product, there's certainly another opportunity over time in the U.S. to get more specific codes for a product like OSIA that makes the reimbursement process simpler.

David Andrew Stanton - *Jefferies LLC, Research Division - Equity Analyst*

So it'd be fair to say that the coding at the moment, in the U.S. in particular, is not optimal?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

It certainly -- look, it's not as good as we would like it to be, but we're -- it's early days in the take-up. We're seeing a good take-up, and there's a whole range of coverage. So you have hospital coding, but then you have insurance coverage that can come over the top of that. So there's a range of insurance companies who are covering, and there's no -- that's as good as -- that is optimal, to use your word. But I think, overall, we could certainly would like to get a bit better reimbursement and coding over time in the U.S.

And we're going to see that in a few other countries as we roll out the -- they want the reimbursement at the price point that is acceptable, there won't be an appropriate code, and we'll need to do work to generate those codes. And that's all part of putting in a product that is new to the world in terms of how it works and in terms of its functionality.

There will be, in many places, need for clinical evidence to support -- to show what great outcomes we're already seeing from the product.

Operator

Your next question comes from Steve Wheen of Evans & Partners.

Steven David Wheen - *Evans & Partners Pty. Ltd., Research Division - Executive Director of Healthcare*

Wanted to drill down on the guidance. You're talking to revised guidance of \$270 million at the lower end. If we were to just annualize first half, which doesn't have any coronavirus type of impact, but bearing that in mind -- but also, you've got a \$10 million benefit from your hedge book, it looks like -- sorry, and the third part to that is you're flagging an acceleration of growth.

It looks like you can pretty easily get to the bottom end of your guidance. So just wondering what sort of am I missing in the first half and one-offs or items that you're not expecting to replicate, just to sort of make. Put the guidance into some perspective.

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

No. Look, I think that's a pretty reasonable conclusion. I mean, obviously, in that low end of guidance, we're assuming a very, very significant reduction of sale in sales to China this half. And that we don't take any action to reducing our cost base in China because this is a temporary issue. So therefore, we'd make a significant loss in China for the half. That's what drives the low end of guidance. Yes, that could all -- we just don't know how the coronavirus could play out. If it does persist for the whole half, then it could be that we end up at the lower end of that guidance range.

Steven David Wheen - *Evans & Partners Pty. Ltd., Research Division - Executive Director of Healthcare*

Yes. Okay. So more specifically in the first half, are you able to give us sort of an idea as to some of those potential one-offs, like the warranty release? And then whether or not you'd be expecting a cycle earn-out provision may be released in the second half just to remove that noise from the result?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Yes. So look, we do expect the release of the cycle provision in the second half at equivalent level to that in the first half. Look, any other provision releases or growth would just be in normal course of business. We don't expect anything significant -- too significant there.

Steven David Wheen - *Evans & Partners Pty. Ltd., Research Division - Executive Director of Healthcare*

And so that warranty, would you sort of give us an idea as to the size of that? And maybe potential offset was what the Brexit-type impact was.

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Yes. Probably not a bad way to think about, yes.

Brent Andrew Cubis - *Cochlear Limited - CFO*

So the -- I mean you can see that in the provisions coming down. Yes, it was -- I think the best way to think about is how you described it. I mean the Brexit almost offsets it.

Operator

Your next question comes from Chris Cooper of Goldman Sachs.



Chris Cooper - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Firstly, I guess just on the rollout of Profile Plus. Can you just confirm whether that product was available in -- I believe it was very good in the U.S. for the whole period. Can you just confirm Germany and the U.K.? Was it true that, that was available for the whole of the first half period?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

So it was certainly available in Germany and the U.S. for the whole of the period, similarly for the U.K.

However, in all of those markets, there's a series of steps to availability. The first of those is regulatory approval, then there can be a sort of country-wide registration process, and that's applicable in France. Then there's often also a hospital registration process. And so while the product was available in all 3 of those markets for -- notionally for the full half, it wasn't available to every hospital and every clinic for the full half because that hospital local registration process can take some time. Now typically, that moves pretty quickly in the U.S., and that's one of the reasons we saw such a strong uplift in the half in the U.S. and can work a bit more slowly through some of the other countries.

Chris Cooper - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Got it. Just on China. I know you answered to a previous question that tenders were negligible as a contribution in the first half of the year. I gather, about a month ago or so, you won a new tender, and it appears that they may have started up again. Do you expect them to pick up and sort of continue again from that sort of pickup we saw a month ago? Or was that just more of a one-off?

And I guess, Part B of that, if things do pick up in terms of the number of tenders being issued, are you going to continue to participate as sort of a gateway to self-pay markets or does that no longer make sense for strategy given some of the sort of pricing declines we've seen in those tender markets for the last few years?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

So we did win or were notionally awarded a share of the China tender with the coronavirus, the signing of all of that gets -- is deferred. But we'd expect to be awarded that when things resume.

That tender is just over 500 units again, and that would ship -- we wouldn't even -- without the coronavirus, we wouldn't have expected that all to ship this half. We carry forward into next year. It's, as I said, a low part of our revenue. However, we are very keen to win tenders and win share of tenders right across the globe. We're very confident of our ability to compete in all tenders, whether they're price-based or whether they're feature-based. And it's -- I think of the advantage we have from the strength of our product portfolio and the scale and experience that impact on our cost base, so that we're well placed to compete anywhere. We want to make sure that we do that and do that effectively.

Chris Cooper - *Goldman Sachs Group Inc., Research Division - Research Analyst*

Got it. And maybe just one for Brent, just at the end. Just on the revaluation of the unlisted investment. I read your comments that -- that's explicitly excluded from your guidance. I mean, it must be up [13%]. Can I just confirm that extends to the impacts on tax, too? I mean I note that probably most of us have a tax rate of 26% for this year. Last year, you had a similar revaluation and that was called out at the time as a driver, the 400 basis point reduction in tax rate that we saw. Can I just confirm that that's not going to be an issue again this year?

Brent Andrew Cubis - *Cochlear Limited - CFO*

No. We've actually allowed for the tax impact of that with Nyxoah. So that's -- you can see that in the tax provision going up. So it will just sit there on the balance sheet until we sell it.

Operator

Your next question comes from David Bailey of Macquarie.

David Bailey - *Macquarie Research - Research Analyst*

Yes. Just for me, I'm just following up from David Low's question earlier about market growth. I mean your competitors did highlight -- one of your competitors highlight some market -- lower market growth in 2019 with ASP or price declines coming through. Just wondering if that's -- if you're seeing any price impacts or price competition in any of your geographies in the first half?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

So as we talked about sort of pricing pressures in -- quite regularly. We definitely see pricing pressure, particularly in Western Europe. Certainly, from what I can see from a medical device perspective, is I think all devices are under pricing pressure, particularly in countries with socialized health care and constrained GDP growth and budgets, they put pressure on prices. So we certainly see that.

In Western Europe, we saw that in the last half and a few instances -- remember, this happens sort of a bit country-by-country, so that it can be not necessary uniform impact. And I think, as our market share has clearly grown and as our market share grows, we expect to often get -- expect or we often see a reaction from our competitors when we have a stronger product portfolio, as we do, that reaction can often be through price.

Brent Andrew Cubis - *Cochlear Limited - CFO*

Sometimes, it's both buying groups as well. We often see that in some of the bigger markets with the bulk buying groups. It's pretty bit of pressure on. But the good thing about it is they actually pay quicker because they do a deal.

David Bailey - *Macquarie Research - Research Analyst*

Got it. And then just in relation to the competitive dynamic. Just any commentary you make in terms of what you -- or how you think competitors or the competitive landscape at the moment versus, say, 2 to 3 years ago?

Diggory William Howitt - *Cochlear Limited - CEO, MD, President & Executive Director*

Look, I don't want to -- I won't speak on behalf of our competitors, but I will talk about how we see our position.

As I've already said, I think we have a very strong product portfolio. At the moment, we have a range of service offerings for clinics and professionals on top of that, which we are -- which we have to aim to make as easy to do business with and we aim to have -- which we do have the most reliable implants on the market, the best range of electrodes in our portfolio, the smallest and most functional externals, that's what we should have, given the scale of our investment in R&D, and that's what we do have right now. So I think we're very confident of our competitive position, albeit that you never know exactly what's around the corner.

We know what we've got in our product pipeline looking forward, and we obviously think it's very strong and very exciting. We don't know what our competitors have in their pipeline.

Operator

Your next question comes from Lyanne Harrison of Bank of America.

Lyanne Harrison - BofA Merrill Lynch, Research Division - VP

Gentlemen, on Acoustics. I guess you mentioned that the CE mark in Europe for the OSIA will take a little bit longer than expected. Do you think in that market that the Baha will be able to maintain its position or will you continue to lose market share in Acoustics?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

We expect -- so we certainly saw a decline in the first half in Europe and we expect to decline over the full year. Some of that is due to a loss of market share, for sure. Some of that is the awareness of OSIA coming but not clarity over when it would eventuate. So we're not quite -- now there's more clarity that, that's still a fair way out. We're not quite sure where that will head.

The other thing that in our Acoustics numbers, it's both a mix of new sales and of Acoustic upgrades. And then, again, we're getting late in the cycle with Baha 5, so a lot of the upgrades that have happened. So in that case, there's probably a decline in our upgrade component of our Acoustic revenue into the second half. So several moving parts. We have forecast a decline in Europe into the second half. We will see how that plays out through this half.

Lyanne Harrison - BofA Merrill Lynch, Research Division - VP

Okay. And then on the emerging markets. Obviously, a very good growth there for the first half. Can you give us some indication of what proportion of the emerging markets is private pay or tender-based?

And then on tenders, would you say that the volume of tenders in the first half is higher than normal or similar to what you've seen previously?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

So we don't disclose sort of for emerging markets overall, just the split between a tender and private pay. And when we look at the breadth of markets we're in, there's actually a number of segments: There's tender, there's private pay, and there's also levels of reimbursement across a number of countries that operate more like -- perhaps what we'd be used to seeing. No, we don't give that split.

Look, part of -- certainly, in the first half, and that good result, there is a reasonable number of deliveries under tender that included in that result. And I say that explicitly because as we said at the full year last year, that we had won a number of tenders across emerging markets that hadn't yet shipped. Those tenders have started to ship through that half. So that's part of what's driven that volume growth. I think we're winning a good share of tenders that we see around the world, and that helps.

So it's many things across a broad range of countries that are driving that growth. Now given the situation in China, we don't expect to see that sort of growth in the second half. However, we are -- continue to be very confident of the long run growth and opportunity in emerging markets.

Operator

Your next question comes from Hashan De Silva of CLSA.

Hashan De Silva - CLSA Limited, Research Division - Research Analyst

Just one from me. With Nyxoah, can you disclose what percentage of ownership Cochlear holds? And what's the long-term strategy with this purchase?

Brent Andrew Cubis - Cochlear Limited - CFO

Just over 20%

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Yes. So we do hold down just over 20%. We don't disclose exactly what it is. And because of that, we do have the equity account for Nyxoah going forward.

Brent Andrew Cubis - Cochlear Limited - CFO

That will only be a couple. It won't be a big amount.

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Yes, it won't. It will be a small amount, and we will exclude it from our -- it will be visible in the reported number, but we'll exclude from our underlying number consistent with how we're trading the investment portfolio.

Operator

Your final question comes from Gretel Janu of Crédit Suisse.

Gretel Janu - Crédit Suisse AG, Research Division - Research Analyst

So just in terms of pricing and gross margin, you called out greater exposure to emerging markets being a bit of a headwind. So roughly, how should we think about the different scenarios playing between developed and emerging markets? And then thinking about the impact on gross margin going forward, are there enough efficiency methods that we should start to see some gross margin improvement?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

So I just missed the last -- what was the -- Gretel, what was the last part of your question?

Gretel Janu - Crédit Suisse AG, Research Division - Research Analyst

Should we start to see some efficiency methods that we'll start to see some gross margin improvements?

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

So we certainly -- look, over time, and Brent has talked extensively on this. We've had some very good efficiency gains both in our manufacturing costs and our warranty that's driven a lift in gross margin by few points over the last few years.

I think it's unlikely to -- that we'd expand the gross margin beyond where it is now. We're certainly not planning on it being bigger than it is now. And the mix of developed and emerging has some impact half-on-half, but over time, I think it looks reasonably consistent.

And again, in emerging markets there, there is a whole range of prices in there. So it's not -- on average, the margin is -- the gross margin is a bit lower, the price is a bit lower. But it depends where we get growth as to -- and the impact on our gross margin is.

Brent Andrew Cubis - Cochlear Limited - CFO

China plant. And the China plant.

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Yes. And we've got -- So we'll be starting up the China factory over the next few years, and that, in the short run, will add a little bit to our COGS because we'll have the overhead of the factory without the volume coming through in the first few years as we make sure that we've got that plant operating very effectively and high quality before we -- with volumes as that will work a bit against us over next couple of years as well.

Gretel Janu - Crédit Suisse AG, Research Division - Research Analyst

Okay. And then just on Slide 10, you called out net profit margin target of roughly 18% that you're still targeting, but that's not included in the guidance slide. So I just wanted to confirm if that is still the target for FY '20 even despite the changes that we've seen in China. And that's being discussed at the downgraded guidance?

Brent Andrew Cubis - Cochlear Limited - CFO

Yes. We're still aiming for that same profit margin even after the update for coronavirus.

Operator

There are no further questions at this time. I'll now hand back to Mr. Howitt for closing remarks.

Diggory William Howitt - Cochlear Limited - CEO, MD, President & Executive Director

Okay. I think we'll finish up there. Thank you all for joining us, and see you over the next few days or otherwise, 6 months' time. Thank you.

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