Company announcement no 2019-14 18 November 2019

Interim Management Statement covering the period year-to-date

Recovery in hearing aid wholesale is progressing as planned and growth momentum is building up
Hearing aid retail business has normalised during November
Continued strong momentum in Hearing Implants and Diagnostics – both unaffected by IT incident
Maintaining outlook for EBIT of DKK 2.0-2.3bn, we expect share buy-backs of DKK 1.0bn in 2019

- Overall, the Group has seen solid growth year-to-date despite a significant, negative impact from the IT incident in September. Growth has been driven by modest organic growth in combination with positive contributions from both acquisitions and exchange rates.
- As previously communicated, the Group's IT infrastructure was hit by cybercrime on 3 September 2019. A ransomware intrusion led us to immediately shut down IT systems across multiple sites and business units, but we have since then managed to recover from back-ups and normalise our IT infrastructure, as communicated on 11 October 2019. After having seen the planned acceleration of growth in the hearing aid wholesale business materialise in July and August, the incident has significantly impacted our ability to operate our business in a normal manner and to execute on our ambitious growth targets in the second half-year. Our hearing aid retail business saw a material impact in September and October, but has normalised during November, and we have seen no noteworthy commercial impact of the IT incident on our Hearing Implants and Diagnostics business activities. For the Group as a whole, we maintain our estimate that the incident will have a total negative financial impact on our reported operating profit (EBIT) in 2019 of DKK 550-650 million.
- In Hearing Devices, growth has been solid year-to-date driven by modest organic growth in our hearing aid wholesale business and acquisitive growth in our hearing aid retail business. Growth in the hearing aid wholesale business has been driven by strong unit growth, whereas growth in the average selling price (ASP) has been negative due to mix changes in the first half-year. In the second half-year, organic growth has so far been flat, as strong organic growth in the first two months of the period driven by new product launches in the first half-year has been offset by the negative effects of the IT incident. The incident has significantly impacted our ability to execute on our ambitious growth targets for the year and has caused constraints in our supply chain that are likely to persist until the end of the year for a small part of the portfolio. Despite a very strong and highly competitive product portfolio and improved sales momentum, we are not likely to fully reach the run rate anticipated before the incident for the remainder of the year.
- In our hearing aid retail business, growth has been driven by acquisitions, which were mainly made in the first half of last year, while organic growth has been flat year-to-date. For the second half-year, organic growth has so far been negative due to the IT incident, which has more than offset solid organic growth generated in July and August. From a commercial perspective, our hearing aid retail business has normalised during November.
- Our Hearing Implants business activity has seen very strong organic growth year-to-date, which has accelerated in the second half-year due to strong sales of the new Ponto 4 sound processor for bone-anchored hearing systems (BAHS) launched in June. Meanwhile, our cochlear implants (CI) business has continued to deliver very strong organic growth. We have seen no commercial impact of the IT incident in this business activity and after a ramp-up period, our cochlear implants production site in France is again operating at normal capacity.
- Diagnostics has continued its organic growth momentum from the first half-year, as North America has continued to perform strongly supported by a significant tender win in the third quarter in our *Other countries* region.
- Sennheiser Communications has continued its growth momentum from the first half-year driven mainly by wireless products in the Mobile Music segment. However, due to product mix changes, exchange rate effects and increased R&D and distribution spend, the contribution to the Group's EBIT is materially lower than for the same period last year.

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- Year-to-date, the Group's gross profit margin has been slightly lower than last year due to a material negative impact of the IT incident. As expected, capacity costs have increased significantly year-over-year, but the sequential development from the first half of 2019 is much more modest. We expect to see low single-digit sequential growth in capacity costs in the second half-year compared to the first half-year driven by acquisitions and costs directly related to the IT incident.
- As a result of the negative impact of the IT incident, we now expect to generate organic sales growth in line with the market growth rate in 2019 (previously above market level). Based on exchange rates as of 15 November 2019 and including the impact of exchange rate hedging, we continue to expect a positive exchange rate effect of 1% on revenue in 2019. As previously communicated, we guide for an EBIT of DKK 2,000-2,300 million, corresponding to an EBIT of DKK 2,650-2,850 million before the IT incident. When excluding the positive impact of IFRS 16, we now expect growth in our cash flow from operating activities (CFFO) to be negative (previously substantial growth) as a result of the IT incident. As of today, we will resume our share buy-backs, and we expect total buy-backs for the year to amount to around DKK 1.0 billion (previously minimum DKK 1.2 billion). As a direct consequence of the IT incident, we expect that at the end of the year our gearing multiple will temporarily exceed our target range of 1.7-2.2 measured as net interest-bearing debt (NIBD), excluding lease liabilities, relative to EBITDA before depreciation related to leased assets (i.e. adjusted for the impact of IFRS 16).

"Looking back at an extremely hectic period for the Group, I'm satisfied that we've now recovered our IT infrastructure and that our business recovery is progressing fast. For the past couple of months, we've done our utmost to reduce the impact of the incident and normalise our operations, and our commitment to delivering innovative products is intact. Despite the past few months' challenges due to cybercrime, we've seen impressive growth in Diagnostics and Hearing Implants, and although our growth in hearing aid retail has been impacted, I'm glad to note that we're back to normal operations. Our hearing aid wholesale business was severely impacted by the incident, and we're working hard and dedicatedly to execute our growth activities and to support our customers by delivering on the strong demand for new hearing aid technology," says Søren Nielsen, President & CEO of Demant.

Hearing Devices

Market trends

We estimate that the global hearing aid wholesale market has seen growth rates year-to-date in line with our general expectation of 4-6% unit growth per year, when adjusting for high growth in the NHS in the UK due to stock building in preparation for Brexit. According to statistics from the Hearing Industries Association (HIA), unit sales in the US increased by 4.9% in the first nine months of the year, with growth in the commercial part of the US market of 4.2% and growth in Veterans Affairs (VA) of 7.9%. Following the passing of the FDA Reauthorization Act of 2017 on 18 August 2017, the US Food and Drug Administration (FDA) will no later than in August 2020 introduce draft legislation to establish a new over-the-counter (OTC) category of hearing aids, but the exact timing has not been confirmed officially. As a member of HIA, we closely monitor and analyse developments and are in active dialogue with the FDA. We maintain our view that any impact of the new OTC category will be limited.

Unit growth in Europe has been very strong year-to-date. In the UK, we saw substantial orders placed by the NHS at the beginning of the year, as they started building stock in preparation for Brexit. We have also seen strong growth in Germany and in several of the small markets in the region. In France too, we have seen a very solid growth rate at wholesale level, even if it decelerated slightly in the third quarter and has been subject to fluctuations driven by the new hearing healthcare reform that took effect on 1 January 2019.

Growth in Japan was solid in the first nine months of the year after accelerating in the third quarter. We estimate that China has continued its double-digit growth in the reporting period.

There are no reliable industry statistics available on the development of prices in the global hearing aid wholesale market, but we believe that the value growth rate in the reporting period has been consistent with our mid- to long-term estimate of 2-4% and that the growth rate is most likely at the upper end of this range, when we adjust for the extraordinary growth in the NHS as described above. As part of this estimate, we still expect slightly negative price development driven by channel and geography mix shifts and a competitive business environment. ASPs on the hearing aid retail market vary significantly across markets because of differences in reimbursement schemes, customer preferences and product mixes, but we lack reliable market statistics.

Wholesale

Our hearing aid wholesale business has year-to-date delivered modest organic growth, as the IT incident offset the solid growth we experienced just prior to the incident. After a slow start to the year, particularly in terms of sales in the premium segment, growth accelerated following the roll-out of new platforms in all brands and in most major markets, which was kicked off at the end of March. Despite a highly competitive environment, particularly in the premium segment, we saw strong growth in the first two months of the second half-year, before the IT incident significantly impacted our ability to service both existing and new customers in September, October and to a lesser extent in November. As a result of the incident, we have been unable to deliver on our ambitious growth targets in the second half-year, and the incident has caused constraints in our supply chain that are likely to persist until the end of the year for a small part of the portfolio. For the remainder of the year, the run rate is therefore likely to be lower than anticipated before the incident, despite our very strong and highly competitive product portfolio and improved sales momentum. Customers have been very understanding of the circumstances, and we estimate that we have not permanently lost existing customers at any material scale, so the expected future impact will relate to business coming from new customers. Specifically for the second half-year, organic growth has so far been flat.

Year-to-date, we have seen strong unit growth driven by sales to the NHS, large retail chains and customers in Asia, particularly China, but ASP growth has been negative due to product mix effects in the first half-year. In the second half-year, both unit and ASP growth rates have been more or less flat, as our improved product mix has been offset by a negative geography mix shift.

A key growth driver year-to-date has been the Oticon Opn S product family, which was introduced at the end of February and rolled out towards the end of March. Overall, the uptake has been very encouraging, particularly in terms of sales of the rechargeable versions, but net sales have been hampered by a significantly higher-than-normal level of returns of products based on legacy silver-zinc rechargeable technology. End-users – while still in their trial period – have chosen to swap their products for the new Opn S because it offers a new, strong rechargeable solution based on lithium-ion technology. This level of returns negatively impacted net sales of premium products up until the end of August, particularly in markets with a high share of rechargeable products, but return rates have since then normalised. Generally speaking, we continue to see strong demand for rechargeable products, which is increasingly extending to the mid-priced segments. In August, Oticon further expanded its product portfolio with the introduction of new, state-of-the-art Super Power and Ultra Power devices for adults and children, including the world's most powerful hearing aid, Oticon Xceed, and with the introduction of the world's first CROS/BiCROS solution featuring TwinLink™ technology. These products create life-changing experiences for people who suffer from severe to profound hearing losses, and we have received very positive feedback and seen strong traction in the first months after the launch.

Following the launch in the first half-year of Philips HearLink, the new product family under our Philips Hearing Solutions brand, we have received very positive feedback and seen a successful uptake in the channels where it has been launched. The timing of the IT incident closely after the launch of the new brand has in some instances caused a delay of the roll-out, but we continue to see a lot of interest in the new products.

Our Bernafon and Sonic brands have also launched new product families in the first half-year as well as new Super Power and Ultra Power devices in August.

In terms of geographies, North America has seen flat organic growth year-to-date. After a slow start to the year, the region saw accelerating growth towards the end of the first half-year and into the second half-year as the new product launches took effect – despite a significantly higher-than-normal number of returned legacy rechargeable products. However, the IT incident has materially impacted growth in the region since September, as it has limited our ability to execute on our ambitious growth activities in the commercial channels, so our focus has turned to re-initiating these activities. Sales to VA were less impacted by the IT incident, but the growth rate has been slightly negative in the second half-year due to strong competition. As planned, we started shipping the new Oticon Xceed products to VA at the beginning of November.

In Europe, we have seen solid organic growth year-to-date driven by the UK where we have seen significant stock building by the NHS in preparation for Brexit as well as by Germany and France. Growth in the second half-year has been modest due to negative effects of the IT incident, which have varied significantly from market to market.

We have seen strong and broadly based growth in Asia, whereas growth has been negative in the Pacific region where the impact of the IT incident has been particularly significant. Our *Other countries* region has seen solid growth year-to-date.

Retail

Growth in our hearing aid retail business has year-to-date been driven by acquisitions and organic growth has been flat as a consequence of the IT incident, which offset the solid organic growth generated prior to the incident. As previously communicated, organic growth has also been negatively impacted by the one-off effect of the French hearing healthcare reform, which took effect at the beginning of the year. Despite solid organic growth in the first two months of the period, organic growth in the second half-year has been negative as a consequence of the IT incident, which resulted in a significant number of clinics being unable to service end-users in a regular fashion in September and to a lesser extent in October. In November, we have seen a normalisation of our commercial operations. Year-to-date, acquisitive growth predominately relates to acquisitions made in the US and France in the first half of 2018, and the effect will therefore gradually decrease during the second half-year.

In North America, we have seen a significant, negative impact of the IT incident and organic growth has been modestly negative year-to-date. In both the US and Canada, organic growth was flat prior to the incident. After the significant negative impact we saw in September and October, the situation has normalised in November. In the US, we have completed a readjustment of our sales organisation and of key management roles, but we still need to further improve processes and marketing initiatives. Acquisitions have contributed significantly to growth in the region year-to-date, driven mainly by the acquisition in the first half of 2018 of the remaining shares of a US-based store network, which was previously recognised as investments in associates.

We have seen solid growth in Europe year-to-date driven by a combination of modest organic growth and acquisitions. Driven by growth in France and Poland, in particular, organic growth in the second half-year has been positive despite the IT incident. These two markets were only modestly impacted, whereas the UK and several other markets have seen a more pronounced effect on their ability to run their business. Following the one-off effect of the reform introduced in France at the beginning of the year, which largely relates to the timing of revenue recognition, growth in France has now normalised at a slightly lower rate and with some fluctuations from month to month. As previously communicated, the reform had a negative one-off impact of approx. DKK 50 million on EBIT in our Hearing Devices business activity, particularly in our hearing aid retail business.

In Australia, our retail business has delivered flat organic growth year-to-date after seeing a very significant negative impact of the IT incident in September and to a lesser extent in October and into November. Prior to the incident, we saw solid organic growth above the market growth rate, as we had successfully adjusted our business model in Australia to reflect changes to our business practices required by the Australian authorities over the last couple of years.

Hearing Implants

Our Hearing Implants business activity has seen very strong organic growth year-to-date with no commercial impact of the IT incident, and we have gained market share in both our CI and BAHS businesses. Our CI business has continued to deliver very strong organic growth in the second half-year driven by the increasing uptake of our Neuro system. Growth has been particularly strong in various export markets as well as in Germany and Brazil, but growth has generally been broadly based. As we have been able to supply products as planned, there has been no commercial impact of the IT incident and after a ramp-up period, our cochlear implants production site in France is now operating at normal capacity.

After seeing modest organic growth in the first half of the year, our BAHS business has seen very strong growth acceleration in the second half-year driven by the launch in June of the new, ground-breaking Ponto 4 sound processor. Based on the latest Velox S hearing aid platform from Oticon, Ponto 4 offers industry-leading audiology, wireless streaming from smartphones and is the smallest product on the market. Year-to-date, growth in the BAHS business has been driven by a number of mature markets.

Diagnostics

In Diagnostics, organic growth has been strong with the momentum from the first half-year carrying over to the second half-year and driven mainly by growth in North America and by a large tender win in the third quarter in our *Other countries* region. Recurring sales of services and disposables have also been an important growth driver. We have seen a minor contribution to growth from acquisitions.

While the IT incident caused some delivery delays in a number of markets, our customers have been understanding of the circumstances, and diagnostic equipment sales are generally less sensitive to slightly longer-than-usual delivery times than other product categories. Sales have mostly shifted within the financial year, and consequently we do not expect any noteworthy commercial impact for the full year.

At the recent EUHA congress in Nuremberg, Germany, Interacoustics launched a new hearing aid fitting system, Affinity Compact, which will help support our growth in this important segment. We have also recently launched new products in several other brands, which we expect will help drive continued market share gains for our Diagnostics business.

Personal Communication

Sennheiser Communications, our 50/50 joint venture with Sennheiser KG, has year-to-date delivered strong organic growth with the momentum gained in the first half-year largely continuing into the second half-year despite very strong comparative figures. Growth has been driven primarily by wireless products in the Mobile Music segment, whereas growth rates in both the Enterprise Solutions and Gaming segment have been lower due to strong comparative figures. The contribution to the Group's EBIT has year-to-date been materially lower than last year due to negative mix changes, exchange rate effects and increased R&D and distribution spend.

Preparations for the announced separation of the joint venture, which will take effect on 1 January 2020, are progressing as planned, and we are confident that the transition for employees, customers, suppliers and partners will be seamless.

Other matters

IT incident

As previously communicated in several company announcements, the Group's IT infrastructure was hit by cybercrime on 3 September 2019. A ransomware intrusion led us to immediately shut down IT systems across multiple sites and business units, but thanks to a great effort by our entire organisation, and – as communicated on 11 October 2019 – we have since then managed to recover from back-ups and normalise our IT infrastructure with support from our global IT partners. For the Group as a whole, we maintain our estimate that the incident will have a total negative financial impact on our reported EBIT in 2019 of DKK 550-650 million. This estimated net effect comprises a negative sales impact of DKK 600-700 million, direct costs of around DKK 50 million and an expected insurance coverage of DKK 100 million. The direct costs are split between production and capacity cost lines, while we expect the insurance coverage to be recognised as a separate item under *Other operating income* before EBIT.

While working to recover and normalise our IT infrastructure, we have focused on leveraging the insights gained in the process to further strengthen our IT security, and we will continue this important work going forward. However, since we have already stepped up our investments in IT security prior to the incident, this will not in itself be a material cost driver for the Group.

Gross profit and capacity costs

Year-to-date, the Group's gross profit margin has been slightly lower than last year's margin due to a material negative impact of the IT incident, as lost sales were not matched by a lower cost base due to the largely fixed cost structure. As expected, capacity costs have increased significantly year-over-year due to our increased R&D efforts in 2018 as well as higher distribution costs, which have mainly been driven by retail acquisitions made in the first half of 2018. However, the sequential development from the first half of 2019 is much more modest, and we expect to see low single-digit sequential growth in capacity costs in the second half-year compared to the first half-year driven by further acquisitions and costs directly related to the IT incident.

Acquisitions

As communicated in our Interim Report 2019, we continue to see attractive acquisition opportunities for all parts of our business. Based on the transactions that we expect to close in 2019, we now expect the level of acquisitions to be slightly below the level seen in 2018 (previously slightly above), although there is some inherent uncertainty about the completion of such acquisitions. As far as some of these acquisitions are concerned, we expect to take full ownership of assets in which we have previously held a non-controlling interest.

Share buy-back

The Company has year-to-date bought back 2,895,269 shares worth a total of DKK 580 million, corresponding to an average purchase price of DKK 200.47. The Company's holding of treasury shares corresponds to approx. 1.2% of the share capital as of today. As previously announced, the Company's buy-back of shares was temporarily suspended on 26 September 2019, pending further clarification of the impact of the IT incident. As of today, we will, however, start to buy back shares, and we expect total share buy-backs to amount to around DKK 1.0 billion for the year, including the shares bought back year-to-date. We continue to aim for a gearing multiple of 1.7-2.2 measured as net interest-bearing debt (NIBD), excluding lease liabilities, relative to EBITDA before depreciation related to leased assets (i.e. adjusted for the impact of IFRS 16). However, we expect that at the end of the year, our gearing multiple will temporarily exceed the target range as a direct consequence of the IT incident, which has significantly impacted reported EBITDA.

IFRS 16

Issued in January 2016, IFRS 16 Leases requires lessees to recognise nearly all leases in the balance sheet with effect from 1 January 2019. Management has decided to apply the modified transition method, whereby comparative figures are not restated. Year-to-date, the financial impact of IFRS 16 has been in line with expectations as communicated in Note 9.1 of our Annual Report 2018 and Note 2 of our Interim Report 2019.

Outlook for 2019

As a result of the negative impact of the IT incident, we now expect to generate organic sales growth in line with the market growth rate in 2019 (previously above market level). Based on exchange rates as of 15 November 2019 and including the impact of exchange rate hedging, we continue to expect a positive exchange rate effect of 1% on revenue in 2019. As previously communicated, we guide for an EBIT of DKK 2,000-2,300 million, corresponding to an EBIT of DKK 2,650-2,850 million before the IT incident. Excluding the positive impact of IFRS 16, we now expect growth in our cash flow from operating activities (CFFO) to be negative (previously substantial growth) as a result of the IT incident. As of today, we will resume our share buy-backs, and we expect total buy-backs for the year to amount to around DKK 1.0 billion (previously minimum DKK 1.2 billion). As a direct consequence of the IT incident, we expect that our gearing multiple will at the end of the year temporarily exceed our target range of 1.7-2.2 measured as net interest-bearing debt (NIBD), excluding lease liabilities, relative to EBITDA before depreciation related to leased assets (i.e. adjusted for the impact of IFRS 16).

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Demant will host a conference call on 18 November 2019 at 14:00 CET. To attend this call, please use one of the following dial-ins: +45 3544 5577 (DK), +44 3333 000 804 (UK) or +1 6319 131 422 (US). The pin code is 11831528#. A presentation for the call will be uploaded on www.demant.com shortly before the call.

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