

Varian Medical Systems (VAR)

\$140.57 (As of 01/31/20)

Price Target (6-12 Months): **\$148.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 11/19/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

3-Hold

Zacks Style Scores:

VGM:D

Value: C

Growth: C

Momentum: F

Summary

Varian exited the fiscal first quarter on a weak note. However, the company continues to gain from its core Oncology Systems segment, which saw solid overseas growth, especially in EMEA and China. In fact, management foresees tremendous opportunities in China owing to the recent tariff exclusions. Gross orders surged in the quarter. Management is optimistic about the recently-closed acquisitions of CyberHeart, Cancer Treatment Services International, Endocare and Aicon. Expansion in gross margin is an added positive. Varian retained its outlook for fiscal 2020. On the flip side, the Proton Solutions unit was weak in the quarter. Moreover, Varian saw some softness in orders in Japan. Reflective of these, the stock has underperformed the industry in a year's time. The stock is overvalued at the moment.

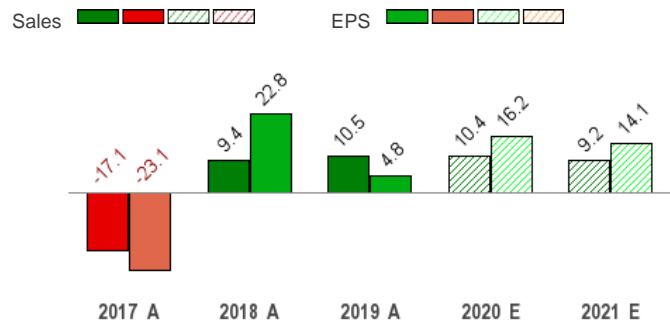
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$150.06 - \$103.92
20 Day Average Volume (sh)	627,951
Market Cap	\$12.8 B
YTD Price Change	-1.0%
Beta	0.89
Dividend / Div Yld	\$0.00 / 0.0%
Industry	Medical - Instruments
Zacks Industry Rank	Top 44% (112 out of 255)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-4.1%
Last Sales Surprise	-0.2%
EPS F1 Est- 4 week change	-0.2%
Expected Report Date	NA
Earnings ESP	-4.0%

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	881 E	932 E	988 E	1,035 E	3,886 E
2020	829 A	864 E	906 E	965 E	3,559 E
2019	741 A	779 A	826 A	879 A	3,225 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$1.37 E	\$1.44 E	\$1.54 E	\$1.66 E	\$6.14 E
2020	\$1.16 A	\$1.26 E	\$1.44 E	\$1.53 E	\$5.38 E
2019	\$1.06 A	\$1.05 A	\$1.32 A	\$1.21 A	\$4.63 A

*Quarterly figures may not add up to annual.

P/E TTM	29.7
P/E F1	26.1
PEG F1	3.3
P/S TTM	3.9

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 01/31/2020. The reports text is as of 02/03/2020.

Overview

Headquartered in Palo Alto, CA, Varian Medical Systems Inc. (VAR) is the world's leading provider of radiotherapy, radiosurgery, proton therapy and brachytherapy for treating cancer and other medical conditions. It is also a premier supplier of X-Ray tubes for medical, scientific, and industrial applications.

The main operating segments are Oncology Systems and Proton Therapy. The company also reports an Other segment that includes Gintzon Technology Center (GTC) and Varian Particle Therapy (VPT) businesses.

On Jan 30, 2017, Varian Medical announced the separation of its Imaging Components Business, which is now established as Varex Imaging Corporation. Notably, the transaction has been completed via a distribution of Varex stock to Varian Medical stockholders of record on January 20, 2017.

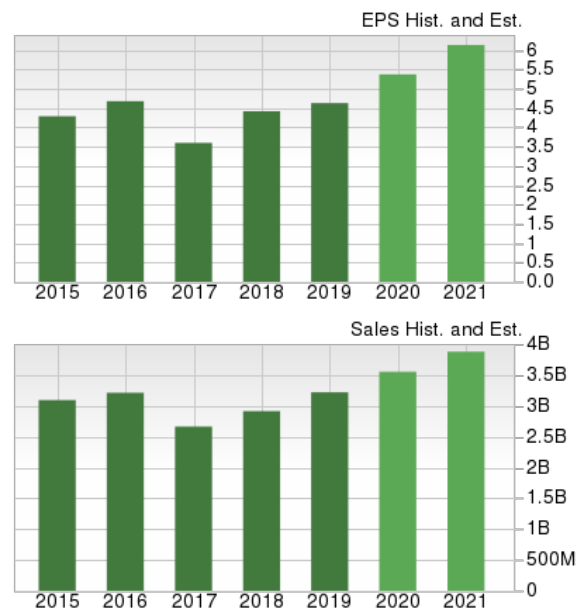
Oncology Systems is Varian Medical's largest operating business segment. It provides products for radiation treatment of cancer with conventional radiation therapy, intensity modulated radiation therapy (IMRT), image guided radiation therapy (IGRT), volumetric modulated arc therapy (VMAT), stereotactic radiosurgery, stereotactic radiotherapy and brachytherapy.

The use of **Proton Therapy** to treat cancerous tumors is a major technological advance. Proton therapy delivers the beam precisely where it is required. Varian's ProBeam system is at the forefront of the industry, having created the world's first commercially available pencil beam scanning system, which is the most precise form of proton therapy available. Currently, proton therapy as a whole is offered at 48 centers worldwide.

FY19 at a Glance

For fiscal 2019, Varian's revenues totaled \$3.23 billion, up 10.5% from fiscal 2018.

For fiscal 2019, revenues at the Oncology unit totaled \$3.06 billion (representing 94.9% of net sales). Revenues at Proton Solutions totaled \$143.9 million (4.5%) while that at the Other unit grossed \$19.4 million (0.6%).



Reasons To Buy:

- ▲ **Guidance Retained:** Despite a dull fiscal first-quarter show, Varian continues to expect revenues within \$3.52-\$3.61 billion, representing year-over-year growth of 9-12% and organic growth of 7-9% for fiscal 2020.

Adjusted earnings per share (EPS) is projected between \$5.30 and \$5.45.

Operating margin is expected between 17.5% and 18.5%, while cash flow from operations is projected in the band of \$450-\$500 million.

- ▲ **Tariff-Exclusion a Positive:** In recent times, Varian's flagship products like medical linear accelerators and radiotherapy system were granted exclusion from additional tariffs imposed by China on the United States. Per management, the tariff exclusions drove the company's gross margin in the fiscal first quarter. The net benefit to quarterly operating earnings was \$23 million. Additionally, Varian expects to recognize a tariff refund in fiscal 2020.

- ▲ **Lucrative Acquisitions:** Varian has been focusing on inorganic growth through its acquisition strategy. In recent times, Varian acquired Cancer Treatment Services International (CTSI) for \$283 million. The collaboration is expected to boost Varian Medical's core Oncology Systems business. The company also expects the buyout to be accretive to earnings per share (EPS) during fiscal 2021 on an adjusted basis and fiscal 2022 on a reported basis. In fact, the CTSI buyout drove the company's Service revenues, which grew 22% in the fiscal first quarter.

The company also announced an asset purchase agreement to acquire Boston Scientific's portfolio of drug-loadable microsphere and bland embolic bead products for \$90 million. This will strengthen Varian's interventional oncology segment. Management is optimistic about recently-closed acquisitions of CyberHeart, Endocare and Alicon.

- ▲ **Machine-Learning Capabilities with RapidPlan:** Machine-Learning or Artificial Intelligence has been taking the MedTech industry by storm. Last October, at the American Society for Radiation Oncology Annual Meeting, Varian shared details of its development work on an artificial intelligence (AI)-driven multimodality adaptive radiotherapy treatment suite that is being designed to deliver high quality treatments.

Additionally, RapidPlan — Varian's unique knowledge-based planning software — was launched by the end of fiscal 2018. Management stated that Varian received nearly 1,800 orders since its launch.

Per management, RapidPlan is currently being utilized in clinical practice by Beijing Cancer Hospital in China.

- ▲ **Halcyon Platform Drives Sales:** The Halcyon radiotherapy treatment system has been designed to offer cost-effective cancer care worldwide. The system streamlines every aspect of image-guided volumetric intensity modulated radiotherapy (IMRT).

Halcyon recently secured approval from the China National Medical Product Administration, which is likely to expand the global availability of Halcyon.

In the first quarter of fiscal 2019, Varian received eight Halcyon orders in Brazil. The company continues to expand access to quality cancer care with the installation of three Halcyon systems at the Centre National d'Oncologie in Mauritania, Centre Hospitalier Nganda in Congo and the Lagos Teaching University Hospital in Nigeria. Halcyon has also been granted exclusion from the section 301 tariffs by the United States Trade Representative, following which, the system received positive feedback.

- ▲ **HyperArc Platform:** HyperArc platform is Varian's high definition radiotherapy technology. Notably, HyperArc is designed to treat multiple metastases brain cancer cases and continues to witness strong demand. Per MarketsAndMarkets, the global radiotherapy market is projected to reach a worth of \$9.47 billion by 2022 from USD 6.81 billion in 2017, at a CAGR of 6.8%. In the first quarter of fiscal 2019, Varian's high-definition radiotherapy solution for HyperArc grew double digits.

Varian has also announced that patients at the Chi Mei Medical Center with brain lesions became the first group in Taiwan to be treated using the company's HyperArc High Definition Radiotherapy system. Other recent software introductions, such as InSightive analytics and 360 Oncology systems, are expected to gather momentum over the long haul.

- ▲ **Solid R&D Prospects:** Varian operates in a technology-driven environment where success depends on innovation and frequent product updates. The company has been successful on the R&D front as evident from year-over-year expansion in its top line. The varied offerings include TrueBeam and Edge platforms, HyperArc, Halcyon, InSightive Analytics, Qumulate QA and RapidPlan knowledge-based treatment planning. We believe that Varian's innovative product pipeline will continue to drive overall growth over the long term. In the fiscal first quarter, research and development expenses rose 10.2% year over year to \$67.1 million.

- ▲ **Notable Developments in Proton Therapy:** In recent times, Varian has seen notable developments in its core Proton therapy unit, which falls under its Particle Therapy business.

For instance, the company's New York Proton Center, the state's first proton therapy facility, treated its first patient on Variance ProBeam Proton Therapy System in recent times. The center is expected to treat 1,400 patients annually.

In the fiscal first quarter, Varian received a new order. Meanwhile, the Proton pipeline remains strong. Also, Varian's ProBeam 360° system was selected by Penn Medicine to be installed at the ancaster General Health Ann B. Barshinger Cancer Institute. Notably, the institute expects to treat its first patient in 2021.

At the end of the fiscal first quarter, Varian was selected by China Medical University Hospital in Taiwan to install a ProBeam 360° system, ARIA information management system, ARIA information management system and the Eclipse treatment planning system. This is scheduled for completion in 2024.

Strong revenue opportunity from its various Oncology and Imaging Component products, growing adoption of Proton Therapy, strong overseas presence, particularly in emerging countries are positives.

▲ **Strength in AI & Medical Mechatronics:** Mechatronics, a high-end technology incorporating electronics, machine learning and mechanical engineering, has been in vogue, of late. A research by the Business Wire deciphers that the global Mechatronics and Robotics market is projected to witness a CAGR of 15.02% during the 2017-2021 period.

Varian has received significant exposure to Medical Mechatronic trends on its Halcyon and HyperArc platforms. In 2018, Varian launched Halcyon 2.0 with kilovoltage imaging (Kv). The first human kV cone-beam CT images on a Halcyon were acquired at Washington University with positive feedback.

Further, Varian's HyperArc platform is designed to treat multiple metastases brain cancer cases and continues to witness strong demand.

▲ **Strong Geographic Foothold:** International emerging markets are a bit under-equipped to address the growing incidence of cancer. The company's strong overseas presence is expected to enable it to leverage this opportunity in emerging markets. Precisely, the company's Oncology Systems segment has been making noteworthy progress worldwide. In the first quarter of fiscal 2020, Oncology revenues came in at \$782.4 million, up 11.4% year over year and 9% at constant currency (cc). Operating earnings at the segment were \$136 million, up 10% year over year. Varian's worldwide net installed base had 8,561 units, up 363 units on a year-over-year basis. As a whole, gross orders grew 8% from the year-ago quarter to \$77.4 million.

Geographically, orders in the United States rose 11% year over year. In EMEA, orders rose 8% year over year. In APAC, orders climbed 9% year over year on growth in China, South East Asia and Korea.

▲ **Recurring Revenue Base:** Service constitutes about one-third of Oncology segment revenues and is recurring in nature. It is expected to further grow as the company expands its installed base in overseas markets, particularly in China and India. The company continues to witness double-digit growth in its service business.

Reasons To Sell:

- ▼ **Shares Down:** Over the past year, shares of Varian rallied 6%, compared with the industry's 8.5%. Meanwhile, the S&P 500 index has increased 17.5%.

Besides stiff competition in the MedTech space, Varian has been facing softness in its Proton therapy unit for a couple of quarters now.

- ▼ **Valuation Looks Dull:** Varian currently trades at a P/S (TTM) ratio of 3.89 compared with 3.49 and 3.71 for the S&P 500 Index and industry, respectively.

- ▼ **Weak Trends:** In the fiscal first quarter, Proton Therapy revenues dropped 28.3% to \$27.6 million. Also, the company continues to witness softness in orders from Japan.

- ▼ **Cutthroat Competition:** Varian competes with large electronic companies such as Siemens and Philips as well as with smaller and more specialized radiation therapy equipment manufacturers like Elekta, Accuray, Philips, Medtronic and Stryker.

In the emerging proton therapy market, the company faces competition from Hitachi, Ion Beam Applications, Mevion Medical Systems and Sumitomo. Intensifying competition is expected to increase R&D expenditures in the nascent proton therapy market, which will keep margins under pressure. Moreover, pricing pressure in traditional radiotherapy also remains a major concern.

- ▼ **Softness in Free-standing Clinics Market:** The ongoing softness in the market for freestanding clinics is a matter of concern. The contribution from the freestanding clinics to the order growth rate in the domestic market was nominal.

Per management, the freestanding clinic market accounts for only 10% of the company's worldwide orders. However, the sustained pressure is expected to have considerable short-term impact on Varian.

Cutthroat competition in the niche space has been a strong headwind for Varian Medical. The company's margin trend has lacked luster over the last few quarters.

Last Earnings Report

Varian Earnings Miss Estimates in Q1, Guidance Retained

Varian reported first-quarter fiscal 2020 adjusted EPS of \$1.16, missing the Zacks Consensus Estimate of \$1.21. The figure however improved 9.4% year over year.

The company reported revenues of \$828.9 million, which lagged the consensus mark of \$830.8 million. On a year-over-year basis, revenues rose 11.9% and 13% atcc. Organically, revenues grew 8%.

Quarter Ending **12/2019**

Report Date	Jan 29, 2020
Sales Surprise	-0.23%
EPS Surprise	-4.13%
Quarterly EPS	1.16
Annual EPS (TTM)	4.74

Segment Details

Oncology Systems: Revenues totaled \$782.4 million, up 11.4% year over year and 9% at cc. Operating earnings at the segment were \$136 million, up 10% year over year.

Varian's worldwide net installed base had 8,496 units, up by 366 units on a year-over-year basis. As a whole, gross orders grew 8% from the year-ago quarter to \$77.4 million.

Orders in the United States rose 7% year over year on 4% growth in North America. In EMEA, orders rose 8% year over year. In APAC, orders climbed 9% year over year driven by growth in China, South East Asia and Korea but partially offset by softness in Japan.

Proton Solutions: Revenues at the segment dropped 28.3% to \$27.6 million. Per management, operating earnings were impacted by project mix and costs.

Other: Revenues at this segment grossed \$18.9 million. For investors' notice, the segment comprises interventional oncology business, including cryoablation, embolic microspheres, and microwave ablation, as well as the company's cardiac radioablation assets.

Margins

Total gross profit in the reported quarter was \$366.8 million, up 16% year over year. Gross margin in the reported quarter was 44.2% of net revenues, up 150 basis points (bps).

Research and development expenses rose 10.2% year over year to \$67.1 million. Selling, general and administrative expenses increased 25.4% year over year to \$177 million.

Adjusted operating income in the fiscal first quarter totaled \$134.6 million, up 12.9% year over year. As a percentage of revenues, operating margin was 16.2%, down 30 bps.

Guidance Retained

For fiscal 2020, Varian continues to expect revenues within \$3.52-\$3.61 billion, representing year-over-year growth of 9-12% and organic growth of 7-9%.

Adjusted EPS is projected between \$5.30 and \$5.45.

Recent News

On **Jan 29**, Varian announced an agreement with Massachusetts General Hospital to provide seven of the company's radiotherapy systems and related services for advanced cancer treatment at its clinics.

Valuation

Varian's shares are down 1.1% and up 6% in the year-to-date period and the trailing 12-month periods, respectively. Stocks in the Zacks sub-industry are down 1.6% while the Zacks Medical Market is down 2.2% in the year-to-date period. Over the past year, the Zacks sub-industry is up 8.5% and sector is down 0.6%.

The S&P 500 index is up 0.1% in the year-to-date period and up 17.4% in the past year.

The stock is currently trading at 24.94X Forward 12-months earnings, which compares to 32.74X for the Zacks sub-industry, 20.68X for the Zacks sector and 18.51X for the S&P 500 index.

Over the past five years, the stock has traded as high as 29.86X and as low as 15.32X, with a 5-year median of 22.43X.

Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$148 price target reflects 26.4X forward 12-months earnings.

The table below shows summary valuation data for VAR.

Valuation Multiples - VAR					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	24.94	32.74	20.68	18.51
	5-Year High	29.86	33.92	21.22	19.34
	5-Year Low	15.32	23.22	15.85	15.18
	5-Year Median	22.43	27.43	18.91	17.46
P/S F12M	Current	3.48	3.63	2.82	3.43
	5-Year High	4.2	3.63	3.82	3.43
	5-Year Low	2.18	2.16	2.43	2.54
	5-Year Median	3.11	2.51	2.95	3
P/B TTM	Current	6.88	4.03	4.41	4.4
	5-Year High	8.53	4.26	5.03	4.54
	5-Year Low	4.09	2.54	3.43	2.85
	5-Year Median	6.2	3.32	4.29	3.62

As of 01/31/2020

Industry Analysis Zacks Industry Rank: Top 44% (112 out of 255)



Top Peers

Accuray Incorporated (ARAY)	Outperform
Becton, Dickinson and Company (BDX)	Neutral
CONMED Corporation (CNMD)	Neutral
Masimo Corporation (MASI)	Neutral
Medtronic PLC (MDT)	Neutral
Novartis AG (NVS)	Neutral
Koninklijke Philips N.V. (PHG)	Neutral
Stryker Corporation (SYK)	Neutral

Industry Comparison Industry: Medical - Instruments				Industry Peers		
	VAR Neutral	X Industry	S&P 500	ARAY Outperform	CNMD Neutral	MASI Neutral
VGM Score	D	-	-	F	A	C
Market Cap	12.78 B	108.20 M	23.55 B	346.31 M	2.89 B	9.10 B
# of Analysts	4	2	13	2	5	2
Dividend Yield	0.00%	0.00%	1.81%	0.00%	0.79%	0.00%
Value Score	C	-	-	D	C	D
Cash/Price	0.04	0.09	0.04	0.25	0.01	0.07
EV/EBITDA	23.63	-0.59	13.97	-203.72	27.32	36.04
PEG Ratio	3.30	2.59	1.97	NA	2.20	2.11
Price/Book (P/B)	6.88	4.39	3.21	8.43	4.12	8.21
Price/Cash Flow (P/CF)	24.68	23.15	13.36	NA	22.95	47.41
P/E (F1)	26.39	29.86	18.42	155.60	33.06	48.42
Price/Sales (P/S)	3.86	3.77	2.60	0.85	3.02	9.96
Earnings Yield	3.83%	-0.59%	5.43%	0.77%	3.03%	2.06%
Debt/Equity	0.06	0.10	0.72	5.22	1.11	0.00
Cash Flow (\$/share)	5.70	-0.06	6.92	-0.01	4.43	3.60
Growth Score	C	-	-	D	A	B
Hist. EPS Growth (3-5 yrs)	0.82%	13.25%	10.68%	NA	7.08%	24.25%
Proj. EPS Growth (F1/F0)	16.09%	20.39%	7.59%	116.67%	16.52%	10.80%
Curr. Cash Flow Growth	7.70%	9.84%	10.81%	-94.34%	11.43%	21.34%
Hist. Cash Flow Growth (3-5 yrs)	0.79%	8.78%	8.78%	14.18%	4.80%	19.43%
Current Ratio	1.29	2.68	1.22	1.94	2.48	6.23
Debt/Capital	5.29%	17.32%	42.99%	83.93%	52.69%	0.00%
Net Margin	8.92%	-15.15%	11.69%	-0.30%	3.00%	20.83%
Return on Equity	24.40%	-17.95%	17.33%	-24.85%	11.18%	17.32%
Sales/Assets	0.83	0.60	0.55	0.94	0.54	0.75
Proj. Sales Growth (F1/F0)	10.35%	10.75%	4.12%	-0.94%	6.53%	9.90%
Momentum Score	F	-	-	D	A	C
Daily Price Chg	-1.64%	-0.80%	-1.98%	2.10%	-2.83%	-0.96%
1 Week Price Chg	-0.48%	0.00%	-1.09%	19.82%	-2.27%	-0.39%
4 Week Price Chg	-2.93%	-1.54%	-2.11%	40.94%	-8.59%	7.58%
12 Week Price Chg	13.86%	1.31%	2.15%	35.54%	-7.12%	20.67%
52 Week Price Chg	6.47%	-12.36%	14.15%	-11.59%	44.53%	37.15%
20 Day Average Volume	627,951	123,798	1,808,632	923,510	338,471	351,845
(F1) EPS Est 1 week change	-0.15%	0.00%	0.00%	7.14%	2.19%	0.00%
(F1) EPS Est 4 week change	-0.15%	0.00%	0.00%	7.14%	1.66%	-0.66%
(F1) EPS Est 12 week change	-0.15%	0.00%	-0.09%	7.14%	1.61%	-0.94%
(Q1) EPS Est Mthly Chg	1.24%	0.00%	0.00%	-100.00%	1.09%	-1.13%

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	C
Growth Score	C
Momentum Score	F
VGM Score	D

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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