

Varian Medical Systems (VAR)

\$149.00 (As of 01/17/20)

Price Target (6-12 Months): **\$156.00**

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:C

Value: C

Growth: C

Momentum: A

Summary

Varian continues to gain from its core Oncology Systems segment, which saw solid 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 Alcon. A solid guidance for fiscal 2020 paints a bright picture as well. Expansion in gross and operating margins is an added positive. The stock has outperformed the industry in a year's time. Varian exited the fiscal fourth quarter on a strong note. On the flip side, the Proton Solutions unit saw a soft quarter. Moreover, Varian's APAC revenues were hurt by headwinds in Japan.

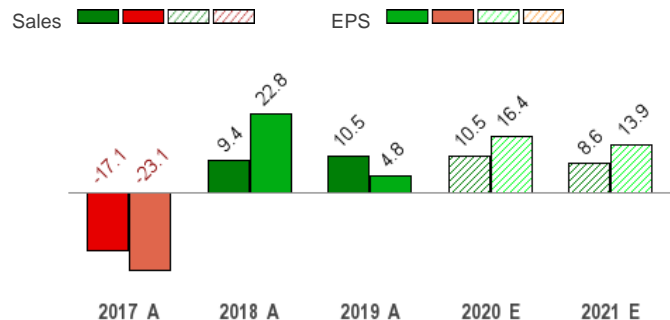
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$149.26 - \$103.92
20 Day Average Volume (sh)	463,120
Market Cap	\$13.5 B
YTD Price Change	4.9%
Beta	0.89
Dividend / Div Yld	\$0.00 / 0.0%
Industry	Medical - Instruments
Zacks Industry Rank	Bottom 39% (155 out of 254)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	0.0%
Last Sales Surprise	3.0%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	01/29/2020
Earnings ESP	0.0%
P/E TTM	32.1
P/E F1	27.6
PEG F1	3.5
P/S TTM	4.2

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	898 E	938 E	979 E	1,017 E	3,872 E
2020	831 E	867 E	908 E	959 E	3,565 E
2019	741 A	779 A	826 A	879 A	3,225 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$1.36 E	\$1.43 E	\$1.53 E	\$1.62 E	\$6.14 E
2020	\$1.21 E	\$1.28 E	\$1.40 E	\$1.51 E	\$5.39 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.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 01/17/2020. The reports text is as of 01/20/2020.

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 Ginzton 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.

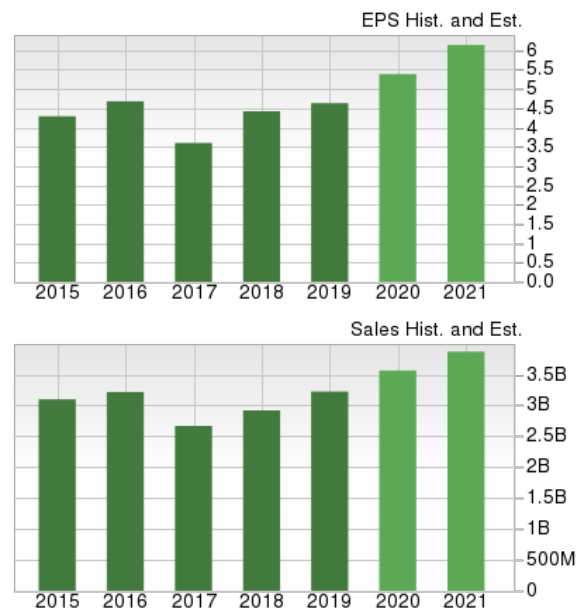
Oncology Systems is Varian Medical's largest operating business segment. It provides products for radiation treatment of cancer with conventional radiation therapy, intensity modulated radiation therapy (IMRT), image guided radiation therapy (IGRT), volumetric modulated arc therapy (VMAT), stereotactic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

- ▲ **Shares Up:** A solid overseas presence and strength in the core Oncology segment continue to favor Varian. Additionally, the company has a strong presence in China and foresees tremendous opportunities in the country, owing to the recent tariff-exclusion for its products.

Reflective of these, over the past year, shares of Varian have gained 16.6% compared with the industry's 14.5% rally. The current level however falls short of the S&P 500 index's 23.8% rise.

- ▲ **Guidance Strong:** For fiscal 2020, Varian expects 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.

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

- ▲ **Margins Shoot up:** Varian has been witnessing dismal margin trends over a couple of quarters. However, in the fiscal fourth quarter, gross profit was \$384.6 million, up 13.6% year over year. Gross margin was 43.8% of net revenues, up 150 basis points (bps). Adjusted operating income totaled \$159.2 million, up 12.7% year over year. As a percentage of revenues, operating margin was 18.1%, up 50 bps.

- ▲ **Tariff-Exclusion a Positive:** Last month, 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 benefited revenues by \$21 million in the fiscal fourth quarter. The net benefit to quarterly operating earnings was \$23 million. Additionally, Varian expects to recognize a tariff refund in fiscal 2020.

- ▲ **Lucrative Acquisitions:** In recent past, Varian announced the buyout of privately-held software company Noona Healthcare, developer of a cloud-based, mobile service designed to capture cancer patient-reported outcomes.

In recent times, Varian acquired Cancer Treatment Services International 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.

The company recently 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 fourth quarter of fiscal 2019, the Halcyon orders grew 30% to 114. Since its launch, Varian has received 398 orders of Halcyon. Per management, the success of Halcyon has been driven by its unique treatment capabilities, smaller size and lower power consumption requirements. Recently, Halcyon was also granted exclusion from the section 301 tariffs by the United States Trade Representative, following which, the system has received positive feedback. In recent times, Varian also received its first order for Halcyon from China.

- ▲ **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 fourth quarter of fiscal 2019, management at Varian confirmed that the HyperArc platform received over 300 orders since launch. Also, orders for the Eclipse Multi Criteria Optimization planning software grew double digits in the quarter.

Earlier this year, Varian 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 fourth quarter, research and development expenses rose 9.4% year over year to \$65.2 million.

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

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.

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 Varian ProBeam Proton Therapy System in the fiscal fourth quarter. The center is expected to treat 1,400 patients annually.

Earlier this year, Varian announced the installation of the gantry for the Varian ProBeam Compact single-room proton therapy system at the new oncology center at Biopolis, an international biomedical research hub in Singapore. Flash and ProBeam 360, Varian's new smaller footprint Proton System are also building momentum for the segment.

In the fiscal fourth quarter, the company took one new order and a total of four orders in fiscal 2019. Currently, Varian has 82 proton orders under contract across 27 sites globally.

- ▲ **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 fourth quarter of fiscal 2019, Oncology revenues came in at \$819.6 million, up 8.5% year over year and 11% at constant currency (cc). Operating earnings at the segment were \$820 million, up 8% 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 7% from the year-ago quarter to \$1.1 billion.

Geographically, orders in the United States rose 11% year over year. In EMEA, orders rose 10% year over year, driven by orders for 13 TrueBeam systems as part of the Tata Trusts framework agreement. China, East Asia and Korea also witnessed growth in the quarter.

Additionally, Varian received 10 Halcyon orders from China in the fiscal fourth quarter. The company also received four VitalBeam systems in Korea and sold the first HyperArc system in Singapore and Hong Kong during the fourth quarter.

- ▲ **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.
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Reasons To Sell:

- ▼ **Valuation Looks Dull:** Varian currently trades at a P/S (TTM) ratio of 4.24 compared with 3.6 and 3.89 for the S&P 500 Index and industry, respectively.
- ▼ **Weak Trends:** In the fiscal fourth quarter, Proton Therapy revenues dropped 8.9% to \$41.9 million. Also, APAC orders declined 9% year over year owing to softness in 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.

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.

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.

Last Earnings Report

Varian Earnings in Line, Revenues Surpass Estimates in Q4

Varian reported fourth-quarter fiscal 2019 adjusted EPS of \$1.21, in line with the Zacks Consensus Estimate. Adjusted EPS surged 4.3% year over year.

The company reported revenues of \$878.9 million, which surpassed the consensus mark of \$853.3 million. On a year-over-year basis, revenues rose 9.6% and 12% at cc.

Segment Details

Oncology Systems: Revenues totaled \$819.6 million, up 8.5% year over year and 11% at cc. Operating earnings at the segment were \$820 million, up 8% 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 7% from the year-ago quarter to \$1.1 billion.

Orders in the United States shot up 11% year over year. In EMEA, orders rose 10% year over year, driven by orders for 13 TrueBeam systems as part of the Tata Trusts framework agreement. In APAC, orders fell 9% year over year with softness in Japan. However, China, East Asia and Korea witnessed growth in the quarter.

Proton Solutions: Revenues at the segment dropped 8.9% to \$41.9 million.

Other: Revenues at this segment grossed \$17.4 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 \$384.6 million, up 13.6% year over year. Gross margin in the reported quarter was 43.8% of net revenues, up 150 bps.

Research and development expenses rose 9.4% year over year to \$65.2 million. Selling, general and administrative expenses increased 26.8% year over year to \$181.6 million.

Adjusted operating income in the fiscal fourth quarter totaled \$159.2 million, up 12.7% year over year. As a percentage of revenues, operating margin was 18.1%, up 50 bps.

Guidance

For fiscal 2020, Varian expects revenues within \$3.52 billion-\$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.

Quarter Ending 09/2019

Report Date	Oct 23, 2019
Sales Surprise	3.01%
EPS Surprise	0.00%
Quarterly EPS	1.21
Annual EPS (TTM)	4.64

Valuation

Varian's shares are up 4.9% and 16.6% in the year-to-date period and the trailing 12-month periods, respectively. Stocks in the Zacks sub-industry are up 3.2% while the Zacks Medical Market is up 2.7% in the year-to-date period. Over the past year, the Zacks sub-industry is up 14.5% and sector is up 4.8%.

The S&P 500 index is up 3.3% in the year-to-date period and up 23.8% in the past year.

The stock is currently trading at 26.54X Forward 12-months earnings, which compares to 34.51X for the Zacks sub-industry, 21.79X for the Zacks sector and 19.2X 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 22.39X.

Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$156 price target reflects 27.9X 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	26.54	34.51	21.79	19.2
	5-Year High	29.86	34.51	21.79	19.34
	5-Year Low	15.32	23.22	15.88	15.17
	5-Year Median	22.39	27.4	18.95	17.44
P/S F12M	Current	3.7	3.69	2.88	3.57
	5-Year High	4.2	3.69	3.81	3.57
	5-Year Low	2.18	2.16	2.42	2.54
	5-Year Median	3.08	2.51	2.93	3
P/B TTM	Current	7.62	4.23	4.61	4.55
	5-Year High	8.53	4.23	5.02	4.55
	5-Year Low	4.09	2.54	3.42	2.85
	5-Year Median	6.16	3.3	4.28	3.61

As of 01/17/2020

Industry Analysis Zacks Industry Rank: Bottom 39% (155 out of 254)



Top Peers

Accuray Incorporated (ARRAY)	Neutral
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	ARRAY Neutral	CNMD Neutral	MASI Neutral
VGM Score	C	-	-	F	B	C
Market Cap	13.55 B	117.51 M	24.65 B	292.00 M	3.14 B	9.05 B
# of Analysts	4	2	13	3	5	2
Dividend Yield	0.00%	0.00%	1.73%	0.00%	0.72%	0.00%
Value Score	C	-	-	D	C	D
Cash/Price	0.04	0.09	0.04	0.37	0.01	0.07
EV/EBITDA	24.90	-0.57	14.11	-180.37	29.20	35.84
PEG Ratio	3.46	2.68	2.08	NA	2.41	2.09
Price/Book (P/B)	7.63	4.68	3.39	7.11	4.47	8.17
Price/Cash Flow (P/CF)	26.16	23.53	13.81	NA	24.94	47.17
P/E (F1)	27.64	30.51	19.19	NA	36.16	48.18
Price/Sales (P/S)	4.20	3.37	2.69	0.71	3.36	9.91
Earnings Yield	3.62%	-0.67%	5.21%	-4.27%	2.77%	2.07%
Debt/Equity	0.00	0.10	0.72	5.22	1.11	0.00
Cash Flow (\$/share)	5.70	-0.06	6.94	-0.01	4.43	3.60
Growth Score	C	-	-	F	A	B
Hist. EPS Growth (3-5 yrs)	0.82%	13.24%	10.56%	NA	7.08%	24.25%
Proj. EPS Growth (F1/F0)	16.31%	20.35%	7.57%	6.67%	15.93%	10.80%
Curr. Cash Flow Growth	7.70%	9.84%	14.73%	-94.34%	11.43%	21.34%
Hist. Cash Flow Growth (3-5 yrs)	0.79%	8.78%	9.00%	14.18%	4.80%	19.43%
Current Ratio	1.27	2.68	1.24	1.94	2.48	6.23
Debt/Capital	0.00%	17.32%	42.99%	83.93%	52.69%	0.00%
Net Margin	9.65%	-15.15%	11.14%	-4.02%	3.15%	20.83%
Return on Equity	24.48%	-17.95%	17.16%	-35.92%	10.50%	17.32%
Sales/Assets	0.87	0.60	0.55	0.97	0.56	0.75
Proj. Sales Growth (F1/F0)	10.54%	11.70%	4.16%	-1.03%	6.53%	9.72%
Momentum Score	A	-	-	C	B	F
Daily Price Chg	0.17%	0.00%	0.27%	-4.37%	-0.20%	-0.05%
1 Week Price Chg	1.17%	0.68%	0.39%	-4.38%	-0.14%	4.35%
4 Week Price Chg	5.03%	3.23%	2.95%	17.56%	0.18%	7.96%
12 Week Price Chg	17.94%	4.59%	7.76%	19.27%	12.81%	19.09%
52 Week Price Chg	18.21%	-8.30%	22.29%	-14.58%	62.85%	44.13%
20 Day Average Volume	463,120	117,754	1,536,375	442,025	254,023	285,350
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	-0.66%
(F1) EPS Est 4 week change	0.00%	0.00%	0.00%	0.00%	0.00%	-0.66%
(F1) EPS Est 12 week change	3.01%	0.09%	-0.40%	2.33%	2.64%	-2.95%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	0.00%	0.00%	0.00%	-1.13%

Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

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	A
VGM Score	C

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.

Disclosures

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