Financial report

Financial review

In the 2017/18 financial year, Sonova generated sales of CHF 2,645.9 million, an increase of 10.4% in Swiss francs or 9.0% in local currencies. Normalized for one-time costs, Group EBITA reached CHF 551.6 million, up 14.6% in Swiss francs or 12.3% in local currencies.

Sales driven by acquisitions and organic growth

In the 2017/18 fiscal year Sonova Group sales reached CHF 2,645.9 million, an increase of 10.4% in Swiss francs. In local currencies sales increased by 9.0%, representing an organic growth of 3.8% plus 6.0% growth from acquisitions, including those made in this reporting period and the full-year effect of prior year acquisitions. The full-year effect mainly consists of five additional months of AudioNova, acquired as of September 2016. Disposals reduced sales growth by 0.8%. Exchange rate fluctuations had a positive impact, and contributed 1.4% to the reported growth in Swiss francs, due to the strength of the Euro.

Strong momentum in the EMEA and APAC regions

Europe, Middle East and Africa (EMEA), the Group's largest region, provided a strong increase in sales of 16.3% in local currencies. We achieved solid organic growth in most markets within the region, supplemented by the full-year effect of the AudioNova acquisition and a further expansion of our retail footprint. This was partially offset by the effects of a difficult market environment in Germany and the Netherlands. The EMEA share of Group sales increased from 48% in 2016/17 to 53% in the period under review.

Sales in the United States declined by 1.8% in local currency from the prior year. Low single-digit growth in the hearing instruments and cochlear implants businesses was more than offset by a lower sales level in the retail network; our project to streamline and reposition this business, which had taken up a significant amount of management attention, is now well advanced. The region accounted for 28% of Group sales in 2017/18, down from 33% in the prior year. The rest of the Americas (excluding the US) achieved a 9.0% sales increase in local currencies, with accelerating growth in the second half year. The strong growth in this region was carried by all three businesses.

Sales in the Asia/Pacific (APAC) region rose by 9.4% in local currencies. Strong growth in Japan and China was partially offset by a weaker development in Australia. The cochlear implants business in China benefited from sales worth CHF 7.7 million made through a central government tender.

Sales by regions

in CHF m			2017/18		2016/17
	Sales	Share	Growth in local currencies	Sales	Share
EMEA	1,398.8	53%	16.3%	1,162.2	48%
USA	759.6	28%	(1.8%)	787.3	33%
Americas (excl. USA)	230.8	9%	9.0%	210.9	9%
Asia/Pacific	256.7	10%	9.4%	235.3	10%
Total sales	**2,645.9**	**100%**	**9.0%**	**2,395.7**	**100%**

Solid gross margin development driven by the hearing instruments segment

Gross profit reached CHF 1,868.2 million, an increase of 13.1% in Swiss francs and of 11.3% in local currencies. The gross profit margin was 70.6%, up from 68.9% in the prior year. This improvement was due both to a higher share of the retail business and an increase in average selling prices across the hearing instruments segment. In the cochlear implants segment, a higher share of upgrade revenues largely offset the impact from the lower-priced China tender.

Reported operating expenses, including other operating income, were CHF 1,335.7 million. This included one-time costs of CHF 19.2 million (2016/17: CHF 18.4 million) related to the AudioNova acquisition, specifically to integration and restructuring. Where relevant, we refer to figures normalized for such one-time costs. Normalized operating expenses rose by 12.5% in Swiss francs or by 10.8% in local currencies to CHF 1,316.6 million, reflecting the sales growth and a business mix effect from the higher relative share of retail business related to AudioNova.

Research and development (R&D) expenses were CHF 142.9 million, an increase of 4.3% in local currencies, underlining Sonova's continued commitment to innovation. Technology developments in the field of wireless connectivity again represented an important share of the R&D efforts. The increased relative share of the retail business means that R&D spending as a percentage of sales declined from 5.7% to 5.4%.

Normalized sales and marketing costs were up 12.3% in local currencies and reached CHF 928.2 million: 35.1% of sales, compared to 33.9% in the prior year. The higher cost ratio is driven by the increased relative share of retail business, which has a higher ratio of sales and marketing costs to sales than the rest of the Group.

Normalized general and administrative costs increased by 9.6% in local currencies to CHF 252.7 million, representing 9.5% of sales, which is unchanged from the prior year. The effect of a generally higher cost ratio from an increased retail business share was offset by firm cost management.

Other income for the current period was largely unchanged at CHF 7.2 million. Similarly to the prior year, this includes a capital gain of CHF 4.0 million (2016/17: CHF 3.9 million) from the sale of non-core retail activities in Europe, which had been part of the AudioNova acquisition.

Reported operating profit before acquisition-related amortization (EBITA) was CHF 532.5 million (2016/17: CHF 463.0 million), an increase of 15.0% in Swiss francs or 12.7% in local currencies. Reported EBITA margin rose to 20.1% (2016/17: 19.3%), mainly reflecting solid operating leverage from organic growth supplemented by a minor benefit from the exchange rate developments. Normalized for one-time costs, EBITA increased by 14.6% in Swiss francs or 12.3% in local currencies to CHF 551.6 million, corresponding to a margin of 20.8%. Including the expected increase in acquisition-related amortization from the AudioNova acquisition, reported operating profit (EBIT) reached CHF 483.0 million (2016/17: CHF 423.7 million), up by 14.0%.

Sonova Group key figures

in CHF m unless otherwise specified	2017/18	2016/17	Change in Swiss francs	Change in local currencies
Sales	2,645.9	2,395.7	10.4%	9.0%
EBITA	532.5	463.0	15.0%	12.7%
EPS (CHF)	6.13	5.35	14.6%	
Operating free cash flow	419.2	424.8	(1.3%)	
ROCE[1]	18.4%	20.4%		
EBITA (normalized)[2]	551.6	481.4	14.6%	12.3%
EBITA margin (normalized)[2]	20.8%	20.1%		
EPS (CHF) (normalized)[2]	6.36	5.58	14.0%	

1) For detailed definitions, please refer to “Key figures”.

2) Excluding one-time costs of CHF 19.2 million (prior year: 18.4 million), consisting of transaction cost and integration related restructuring costs in connection with the acquisition of AudioNova.

Significant increase in earnings per share

Reflecting the strong growth in EBIT, basic earnings per share (EPS) reached CHF 6.13 (2016/17: CHF 5.35), a significant increase of 14.6% from the prior year. Normalized for one-time costs, EPS increased 14.0% to CHF 6.36. Net financial expenses, including the result from associates, decreased from CHF 6.3 million to CHF 4.0 million. The effective tax rate was 14.9% (2016/17: 14.7%); the increased rate reflects a negative impact from revaluation of tax loss carry forwards related to the US tax reform, mostly offset by the revaluation of other tax assets and liabilities. Income after taxes was therefore CHF 407.4 million (2016/17: CHF 356.2 million).

Minor increase in headcount

The Group’s total workforce at the end of the 2017/18 financial year was 14,242 full-time equivalents, an increase of only 153 over the previous year after taking into account acquisitions and disposals, including the sale of our US Hearing Service Plan business at the end of the fiscal year. In line with our strategy, we continued to add staff in customer facing functions and in R&D. Good progress was made in directing new hires to lower-cost locations.

Hearing instruments segment – Acquisitions and new products driving growth

Sales in the hearing instruments segment grew by 10.6% in Swiss francs and 9.0% in local currencies to reported sales of CHF 2,423.1 million. Organic growth was 3.3%, while the contribution from acquisitions in the reporting period and the full-year effect of prior year acquisitions was 6.6% or CHF 143.8 million. Growth was reduced by 0.9% through disposals, mainly in the retail business. Exchange rate fluctuations, primarily a stronger Euro, contributed 1.6% to growth in Swiss francs.

As in the prior year, Premium hearing instruments achieved the strongest growth, with sales up 11.8% in local currencies. This was followed by the Advanced and Standard categories with an increase of 5.4% and 4.5% respectively in local currencies. The higher growth in the Premium category was driven by the continuing success of our innovative product portfolio, in particular the further expansion of our rechargeable solutions and the launch of our industry-first hearing aid with direct universal wireless connectivity functionalities, which generated ongoing improvement in the product mix and average selling prices. Sales of wireless communication systems showed good momentum with a rise of 7.7% in local currencies, almost exclusively from organic growth. Sales in the “miscellaneous” product category, which includes accessories, batteries, and services, increased strongly by 20.4% in local currencies, both from solid organic growth and the full-year effect of the AudioNova acquisition, which has a higher revenue share in this category.

Sales by product groups – Hearing instruments segment

in CHF m			2017/18		2016/17
	Sales	Share	Growth in local currencies	Sales	Share
Premium hearing instruments	679.0	28%	11.8%	604.5	28%
Advanced hearing instruments	497.7	21%	5.4%	464.7	21%
Standard hearing instruments	761.3	31%	4.5%	713.9	32%
Wireless communication systems	115.8	5%	7.7%	106.7	5%
Miscellaneous	369.3	15%	20.4%	300.5	14%
Total hearing instruments segment	**2,423.1**	**100%**	**9.0%**	**2,190.3**	**100%**

The hearing instruments business, which includes sales to independent audiologists, retail chains, multinational, and government customers, but excludes our own retail business, grew 4.2% in local currencies to CHF 1,441.6 million. Organic growth was 4.7%, driven by the rechargeable and wireless connectivity innovations mentioned above, along with the further deployment of the Phonak Belong™ and the Unitron Tempus™ platforms. Solid growth was achieved across all regions, with double-digit organic growth in major markets including Canada, France, UK, Italy and Japan, partially held back by a more modest development in Germany and the United States.

The retail business increased sales by 17.2% in local currencies to CHF 981.5 million; growth was driven by acquisitions and improving organic sales development in the second half. Solid organic growth in a number of key markets, including UK, Belgium, Canada, France, Poland and New Zealand, was partially offset by a weaker development in Germany and Australia. In addition, business in the US and the Netherlands continued to be affected by the streamlining and strategic repositioning of our store networks, which is in an advanced stage. The integration of the AudioNova acquisition has further progressed and the conversion of its product portfolio to Sonova technology has been completed ahead of plan.

Growth was also affected by the sale of non-strategic retail assets, including the AudioNova businesses in France and Portugal in March and April 2017 respectively.

Sales by business – Hearing instruments segment

in CHF m	2017/18			2016/17	
	Sales	Share	Growth in local currencies	Sales[1]	Share[1]
Hearing instruments business	1,441.6	59%	4.2%	1,377.2	63%
Retail business	981.5	41%	17.2%	813.1	37%
Total hearing instruments segment	**2,423.1**	**100%**	**9.0%**	**2,190.3**	**100%**

[1] Reclassification of US insurance subcontracting business from Retail (as disclosed in the annual report 2016/17) to Hearing instruments business.

Reported EBITA for the hearing instruments segment amounted to CHF 520.6 million, up 12.1% in local currencies. The normalized EBITA increased by 11.7% in local currencies to CHF 539.7 million, corresponding to an EBITA margin of 22.3% (prior year: 21.6%). The segment achieved strong organic margin expansion through a positive product mix and strict cost control, partially offset by the expected margin effect of the increased share of retail business.

Cochlear implants segment – Growth driven by upgrade sales

The cochlear implants segment achieved sales of CHF 222.9 million, up 8.5% in Swiss francs and 8.6% in local currencies; the main driver was a 27.5% local currency growth in upgrade sales. After a double-digit increase in the prior year, sales growth in Western markets was slower, due to increased competition and strict internal price discipline. The Asia/Pacific region significantly outperformed, even excluding the CHF 7.7 million in sales related to the government tender in China. New systems sales rose by 3.3% in local currencies. The range of bimodal solutions was further expanded by the launch of the Phonak Naída™ Link CROS, a wireless audio transmitter that provides full access to sounds for unilateral cochlear implant candidates with no hearing in their opposite ear. The year also saw the successful introduction of the HiFocus™ SlimJ electrode, featuring a thin, straight design that helps to preserve residual hearing.

Sales by product groups – Cochlear implants segment

in CHF m	2017/18			2016/17	
	Sales	Share	Growth in local currencies	Sales	Share
Cochlear implant systems	165.1	74%	3.3%	160.0	78%
Upgrades and accessories	57.8	26%	27.5%	45.4	22%
Total cochlear implants segment	**222.9**	**100%**	**8.6%**	**205.4**	**100%**

Stable average selling prices in developed markets and an increased share of high-margin upgrade sales largely offset the impact of the lower-priced China tender on the gross profit margin. Together with a good operating leverage, this resulted in an EBITA of CHF 11.9 million versus CHF 8.0 million in the prior year.

Stable cash flow

Cash flow from operating activities was CHF 523.4 million, compared to CHF 522.4 million in the prior year; higher profitability was offset by adverse changes in working capital and long-term provisions. Compared to the prior year, movements in trade payables, rebounding from an elevated prior year level, and lower income tax accruals reduced cash flow by a total of CHF 33.2 million. Two other items, each of which had a negative impact in the high single-digit millions, were higher accounts receivables, and the liquidation of AudioNova legacy equity plans. Net investments in tangible and intangible assets were largely unchanged at CHF 95.5 million, resulting in an operating free cash flow of CHF 419.2 million, down by 1.3%. Cash consideration for acquisitions amounted to CHF 82.5 million, compared to 675.3 million in the prior year, which had included the acquisition of AudioNova. Cash inflow from divestments was CHF 23.3 million, against CHF 17.8 million in the prior year. In summary, this resulted in a free cash flow of CHF 360.0 million, compared to a negative free cash flow of CHF 232.6 million in the prior year.

Cash outflow from financing activities was CHF 186.2 million, compared to a cash inflow of CHF 290.5 million in the prior year, which had included the bond issue related to the financing of the AudioNova acquisition. A net amount of CHF 26.3 million was spent on the purchase of treasury shares to support equity-based compensation plans, compared to CHF 20.8 million in the prior year. Cash outflow from financing also includes dividend payments of CHF 150.3 million.

Balance sheet remains strong

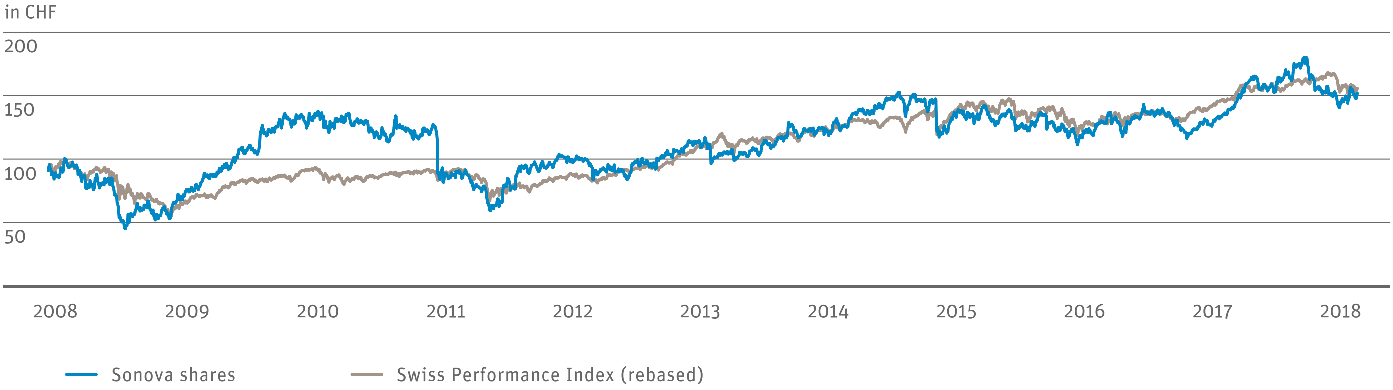
Reported net working capital was CHF 190.5 million, compared to CHF 169.7 million at the end of the prior year; this reflects a slight deterioration in working capital ratios and acquisition effects. Capital employed was CHF 2,702.9 million, compared to CHF 2,535.9 million in the prior year; the increase was largely driven by the acquisitions and currency effects on balance sheet positions. The Group's equity position amounted to CHF 2,474.9 million, resulting in a solid equity ratio of 57.5%. The net debt position stood at CHF 228.0 million, compared to CHF 404.6 million at the end of the prior year. Reflecting the full year impact of the acquisition of AudioNova, the return on capital employed (ROCE) showed an expected decrease to 18.4% from 20.4% in the prior year.

In light of the solid profitable growth and a healthy financial position, the Board of Directors will propose a dividend of CHF 2.60 to the Annual General Shareholders' Meeting on June 12, 2018. This proposed distribution is up 13% over the prior year, and represents a stable payout ratio, normalized for one-time cost, of 41% (reported: 42%).

Outlook 2018/19

We expect continued solid growth in sales and profitability across the hearing instruments and cochlear implants segments during 2018/19, supported by our attractive product and solutions portfolio and our continued commitment to innovation. The disposal of non-core retail assets and the US Hearing Service Plan business is expected to reduce growth by around 1% with a small impact on profitability. We therefore expect overall sales to grow in the range of 2%–4% in local currencies.

Share price development – Sonova versus Swiss Performance Index (rebased)



Share price performance history[1]

	10 years	5 years	3 years	2 years	1 year
Sonova shares	66.6%	33.3%	12.2%	23.6%	9.3%
Swiss Performance Index (SPI)[2]	70.9%	40.7%	11.5%	22.5%	5.7%
Sonova shares relative to the SPI	(4.3%)	(7.4%)	0.7%	1.1%	3.6%

1) Performance of the Sonova shares and SPI refers to the respective period prior to the last trading day of the 2017/18 financial year.

2) The Swiss Performance Index (SPI) is considered Switzerland's overall stock market index. It comprises practically all of the SIX Swiss Exchange-traded equity securities of companies that are domiciled in Switzerland or the Principality of Liechtenstein.