

Nevro

Quarterly Results In-line with Preannouncement; Hiring in Focus for 2H18

Nevro reported 2Q results and 2018 guidance in-line with preannounced results Thursday after the close. To recap, the company previously reported better than expected 2Q18 results as sales of \$96.1M came in \$1M above the Street off a stronger US performance. This was coupled with a largely in-line performance down the P&L, with gross margins in-line, SG&A 110bps above, and R&D 50bps below. Management also reiterated 2018 guidance of \$385-390M (+18-19%), a step down from the prior range of \$400-410M (+25-29%) and below Street expectations for \$402M before the preannouncement. With the quarter behind it, we expect Nevro to put a significant management focus on (1) finding the right VP of Sales, which could take time, and (2) accelerate rep hiring. With expectations reset after (a) Nevro successfully defended its method of use patents ([here](#)) and (b) Boston publically stating they currently don't have any intentions of entering the HF market ([here](#)), we continue to see upside and reiterate our OW rating.

- **To recap, sales of \$96.1M (+23%) came in ~\$1M above consensus before the preannouncement.** Outperformance largely came from the domestic business, where sales of \$79.9M (+27%) were \$1.7M above the Street. On the other hand, the OUS business came in at \$16.2M (+8%), a number that disappointed by \$0.7M after expectations for a recovery to more of a high-single-digit/low-double-digit cc range didn't materialize in the quarter.
- **The quarter itself was fine, but lowered guidance for the year points towards growth of 12-15% in the back half of the year.** This marks a significant deceleration from the 25% growth posted by the company in 1H18 due to: (1) a disruption in sales rep hiring as attrition outstripped new rep hires, which is expected to take at least one more quarter to address; (2) continued headwinds to the OUS business as capitation and increasing share drove down growth; and (3) headwinds from competitor trialing of new products.
- **The hiring issue is likely the most important, with Nevro unable to adequately address attrition.** Management highlighted attrition of 15-20% on the preannouncement, a degree of annual attrition that is already a step above sales rep turnover in our MedTech universe. While Nevro called out 10-15% as a normal level of attrition for companies in the SCS space, the company's ongoing efforts to improve retention and improve hiring will take time. In the meantime, a flat to down sales headcount leads us to model US growth of 15% in 2H18 and 20% in 3Q18, the company's first 2Q to 3Q sequential decrease.

Nevro Corp. (NVRO;NVRO US)

FYE Dec	2017A	2018E (Prev)	2018E (Curr)	2019E (Prev)	2019E (Curr)	2020E (Prev)	2020E (Curr)
EPS - Recurring (\$)							
Q1 (Mar)	(0.50)	(0.59)A	(0.59)A	-	-	-	-
Q2 (Jun)	(0.40)	(0.39)	(0.35)A	-	-	-	-
Q3 (Sep)	(0.21)	(0.31)	(0.51)	-	-	-	-
Q4 (Dec)	(0.15)	(0.14)	(0.25)	-	-	-	-
FY	(1.24)	(1.43)	(1.71)	(0.83)	(1.05)	(0.43)	(0.63)
Revenue FY (\$ mn)	327	387	387	435	437	488	491

Source: Company data, Bloomberg, J.P. Morgan estimates.

See page 6 for analyst certification and important disclosures.

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Overweight

NVRO, NVRO US

Price: \$59.55

Price Target: \$77.00

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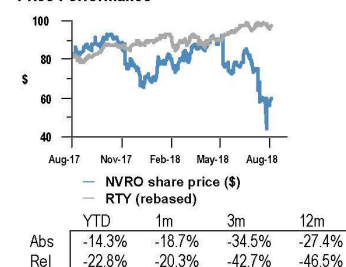
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Price Performance



Company Data

Price (\$)	59.55
Date Of Price	02-Aug-18
52-week Range (\$)	94.34-35.41
Market Cap (\$ mn)	1,788.23
Fiscal Year End	Dec
Shares O/S (mn)	30
Price Target (\$)	77.00
Price Target End Date	31-Dec-19

- **Management maintained its stance on the competitive environment.** On a more direct front, we expect continued aggressive sales and marketing efforts from large-cap competitors are also playing a role in the company's commercial troubles as new products and increased trialing impact sales. We continue to see Senza and Senza II as the highest quality products on the market today, but the breadth and scale of Nevro's competitors help even the playing field. For 2018 we model US SCS market growth of 15%, with Nevro share increasing 90bps y/y as 1H share gains of 140bps moderates to just 40bps in 2H. Part of this is due to the sales rep hiring disruption, while the other is most likely increased competitive pressure from Medtronic and Boston Scientific on new product launches following several years of share losses.
- **On the other hand, the recent outcome in the company's legal dispute with Boston has been a clear positive for Nevro.** A direct statement from Boston around its intent to avoid the U.S. HF market, for now, holds weight and is largely in-line with our expectations following the final summary judgment earlier in July. As a reminder, even though it looks like Boston came out ahead in summary judgment by (a) avoiding infringement of Nevro's HF patents and (b) nullifying four of Nevro's patents, (1) Boston only had low frequency tonic stim devices, so it makes sense it didn't infringe the HF patents, and (2) Nevro's remaining three method of use patents likely remain more than enough to block a competitive HF launch.
- **To close out the quarter, results down the P&L were largely in-line.** Gross margins of 70.7% were in-line with Street expectations while R&D came in 50bps better than expected (11.9% vs. 12.4%), offset by SG&A which came in 110bps higher (67.3% vs. 66.2%) off of higher legal expenses (\$5.8M vs. \$4.0M) and a \$6.4M increase in personnel costs. All told, this led to a net loss of \$10.6M in the quarter, of \$0.35 per share, a step below Street expectations for \$0.28.
- **We continue to view the \$385-390M 2018 sales guidance range as a more appropriate target.** For the full year, we now model sales of \$387M (+19%), with US sales of \$320M (+22%) and OUS sales of \$67M (+6%). We also expect the company will hire 3 reps in the back half of the year, which would put the company at 294 reps exiting 2018 and represents just 6% y/y rep growth. With hiring looking to pick up in 2019, we model sales growing to \$437M (+13%) with 30 net adds, while in 2020 we model sales growing to \$491M (+12%) with 15 net hires.

Investment Thesis, Valuation and Risks

Nevro (*Overweight; Price Target: \$77.00*)

Investment Thesis

Following the 2Q pre-announcement, the bar for performance has been significantly lowered, which had been a growing investor concern of late. To be clear, we do believe Nevro's near-term outlook will be challenged as it works to overcome internal rep hiring headwinds, continued disruption in the OUS market, and increasing competitive pressures. However, with the bar reset and the stock now trading at a severe discount to peers, we see significant room for upside.

Support for Senza remains strong, with feedback to date showing that (1) uptake and utilization in the US are robust; (2) Senza is driving SCS market acceleration and expansion into the underserved back pain segment; (3) there is a growing preference for paresthesia-free therapy with strong, clinically proven patient outcomes; and (4) real-world results are reflective of the outstanding results seen in the US pivotal SENZA-RCT trial, which now has two years of durable outcomes.

We believe Senza is a platform technology; over the next 12+ months, we expect Nevro to initiate a number of larger trials to support the second wave of growth. Nevro's broad label today already allows for the treatment of Virgin Back and Upper Limb; however, the issue is reimbursement, which will require larger trials to secure. A Neck pain indication falls outside the scope of Senza's label and will therefore require a pivotal trial for both label expansion and reimbursement. We expect Nevro to initiate several trials over the next year or so, with the first of these a randomized clinical trial in diabetic neuropathy in the process of enrolling centers. Looking further, we see the potential for Senza in (1) Virgin Back, especially now that the paddle lead is approved, as this trial will need to be championed by the neurosurgeon community, (2) Upper Limb, and (3) Neck pain.

Valuation

With our updated numbers Nevro currently trades at 3.7x NTM EV/sales, a discount to 5x EV/Sales that other mid-teens growth companies are valued at. It will take time for management to right the ship, but we do not think the Nevro growth story is broken beyond repair. Our December 2019 price target is \$77 per share, or 5.0x 2020E revenues, which we view as an appropriate valuation for a company growing mid teens.

Risks to Rating and Price Target

Risks to our Overweight rating include: (1) the SCS market is highly concentrated with entrenched competitors that are larger than Nevro; (2) competitors are developing novel systems—both high and intermittent frequency at lower amplitudes—to respond to the Nevro challenge; and (3) Nevro's intellectual property is likely to face legal challenges as competitors attempt to follow Nevro's path.

Nevro: Summary of Financials

Income Statement - Annual						Income Statement - Quarterly					
	FY16A	FY17A	FY18E	FY19E	FY20E		1Q18A	2Q18A	3Q18E	4Q18E	
Revenue	229	327	387	437	491	Revenue	88A	96A	96	108	
COGS	(75)	(99)	(113)	(121)	(131)	COGS	(26)A	(28)A	(28)	(31)	
Gross profit	153	228	274	315	360	Gross profit	62A	68A	68	77	
SG&A	(142)	(220)	(273)	(290)	(311)	SG&A	(67)A	(65)A	(70)	(71)	
Adj. EBITDA	(8)	0	(9)	5	23	Adj. EBITDA	(15)A	(7)A	(13)	(5)	
D&A	(2)	(3)	(3)	(4)	(5)	D&A	(1)A	(1)A	(1)	(1)	
Adj. EBIT	(10)	(2)	(12)	1	18	Adj. EBIT	(16)A	(8)A	(14)	(6)	
Net Interest	(5)	(7)	(6)	(3)	(1)	Net Interest	(2)A	(1)A	(1)	(1)	
Adj. PBT	(17)	(8)	(19)	(2)	16	Adj. PBT	(17)A	(10)A	(15)	(7)	
Tax	(2)	(1)	(1)	(3)	(3)	Tax	(0)A	(0)A	(0)	(0)	
Minority Interest	-	-	-	-	-	Minority Interest	-	-	-	-	
Adj. Net Income	(32)	(37)	(51)	(35)	(21)	Adj. Net Income	(18)A	(11)A	(15)	(8)	
Reported EPS	(1.12)	(1.24)	(1.71)	(1.05)	(0.63)	Reported EPS	(0.59)A	(0.35)A	(0.51)	(0.25)	
Adj. EPS	(1.12)	(1.24)	(1.71)	(1.05)	(0.63)	Adj. EPS	(0.59)A	(0.35)A	(0.51)	(0.25)	
DPS	-	-	-	-	-	DPS	-	-	-	-	
Payout ratio	-	-	-	-	-	Payout ratio	-	-	-	-	
Shares outstanding	28	29	30	33	34	Shares outstanding	30A	30A	30	30	
Balance Sheet & Cash Flow Statement						Ratio Analysis					
	FY16A	FY17A	FY18E	FY19E	FY20E		FY16A	FY17A	FY18E	FY19E	FY20E
Cash and cash equivalents	41	43	140	194	225	Gross margin	67.0%	69.7%	70.8%	72.2%	73.3%
Accounts receivable	53	69	85	96	108	EBITDA margin	(3.5%)	0.0%	(2.4%)	1.1%	4.6%
Inventories	85	98	84	72	71	EBIT margin	(4.2%)	(0.7%)	(3.1%)	0.2%	3.6%
Other current assets	241	232	120	64	36	Net profit margin	(13.9%)	(11.2%)	(13.3%)	(8.0%)	(4.3%)
Current assets	420	442	429	426	441	ROE	(13.1%)	(14.7%)	(21.3%)	(15.2%)	(9.0%)
PP&E	7	9	11	15	19	ROA	(8.8%)	(8.3%)	(11.4%)	(7.8%)	(4.6%)
LT investments	-	-	-	-	-	ROCE	(3.3%)	(0.7%)	(3.4%)	0.6%	3.8%
Other non current assets	3	4	5	5	5	SG&A/Sales	62.3%	67.3%	70.4%	66.4%	63.3%
Total assets	431	455	445	446	465	Net debt/equity	38.8%	40.8%	2.2%	(21.6%)	(33.3%)
Short term borrowings	0	0	0	0	0	P/E (x)	NM	NM	NM	NM	NM
Payables	16	18	21	23	24	P/BV (x)	6.8	7.0	7.7	8.7	8.4
Other short term liabilities	26	40	45	48	52	EV/EBITDA (x)	NM	13,698.6	NM	361.4	75.0
Current liabilities	42	58	66	71	77	Dividend Yield	-	-	-	-	-
Long-term debt	138	145	145	145	145	Sales/Assets (x)	0.6	0.7	0.9	1.0	1.1
Other long term liabilities	1	2	2	2	2	Interest cover (x)	NM	0.0	NM	1.8	15.4
Total liabilities	182	205	213	218	224	Operating leverage	(36.1%)	(175.8%)	2231.1%	(837.3%)	15665.5%
Shareholders' equity	249	250	232	228	241	Revenue y/y Growth	228.3%	43.0%	18.6%	12.8%	12.4%
Minority interests	-	-	-	-	-	EBITDA y/y Growth	(85.4%)	(101.7%)	(6719.9%)	(152.7%)	373.4%
Total liabilities & equity	431	455	445	446	465	Tax rate	(9.7%)	(17.5%)	(8.0%)	(138.1%)	18.5%
BVPS	8.74	8.49	7.70	6.82	7.13	Adj. Net Income y/y Growth	(52.9%)	15.4%	40.3%	(32.2%)	(39.3%)
y/y Growth	(1.0%)	(2.9%)	(9.4%)	(11.4%)	4.5%	EPS y/y Growth	(56.1%)	11.6%	37.1%	(38.7%)	(40.1%)
Net debt/(cash)	97	102	5	(49)	(80)	DPS y/y Growth	-	-	-	-	-
Cash flow from operating activities	(59)	(14)	(10)	5	12						
o/w Depreciation & amortization	2	3	3	4	5						
o/w Changes in working capital	(54)	(17)	5	6	(6)						
Cash flow from investing activities	(132)	4	108	49	19						
o/w Capital expenditure	(3)	(4)	(6)	(7)	(10)						
as % of sales	1.5%	1.3%	1.5%	1.7%	1.9%						
Cash flow from financing activities	145	11	0	0	0						
o/w Dividends paid	-	-	-	-	-						
o/w Net debt issued/(repaid)	147	0	0	0	0						
Net change in cash	(45)	1	97	54	31						
Adj. Free cash flow to firm	(62)	(19)	(16)	(2)	3						
y/y Growth	(41.3%)	(69.9%)	(13.4%)	(85.8%)	(217.7%)						

Source: Company reports and J.P. Morgan estimates.

Note: \$ in millions (except per-share data). Fiscal year ends Dec. o/w - out of which

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Nevro (NVRO, NVRO US) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
14-Dec-15	OW	64.16	80.00
10-May-16	OW	68.36	84.00
09-Aug-16	OW	94.56	100.00
24-Oct-16	OW	100.14	112.00
07-Nov-16	OW	89.12	106.00
23-Feb-17	OW	98.97	112.00
08-May-17	OW	86.30	102.00
07-May-18	OW	77.59	98.00
16-Jul-18	OW	58.71	77.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Dec 01, 2014.

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