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RMD - Q4 2017 Resmed Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 revenues of $556.7m and non-GAAP net income of $109.6m and non-GAAP diluted EPS of $0.77.

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PRESENTATION

Operator

Welcome to the Q4 Fiscal Year 2017 ResMed Inc. Earnings Conference Call. My name is Mariama, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

I will now turn the call over to Agnes Lee, Vice President, Investor Relations and Corporate Communications. Agnes, you may begin.

Agnes Lee - *ResMed Inc. - Vice President, Investor Relations and Corporate Communications*

Thank you, Mariama, and thank you for attending ResMed's live webcast.

Joining me on the call today are Mick Farrell, our CEO; and Brett Sandercock, our CFO. Other members of the management team will also be available during the Q&A portion of the call. If you have not had a chance to review the earnings release, it could be found on our website at investor.resmed.com.

I want to remind our listeners that our discussion today may include forward-looking statements, including, but not limited to, statements about future expectations, plans and prospects for the company, corporate strategy, integration of acquisitions and performance.

We believe these statements are based on reasonable assumptions, but actual results may differ materially from those indicated. Important factors which could cause actual results to differ materially from the forward-looking statements are detailed in filings made by ResMed with the SEC.

I will now hand the call over to Mick Farrell.

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Thanks, Agnes, and thank you to all of our shareholders joining us today as we review financial results for the fourth quarter of fiscal year 2017.

For the call today, I will review top-level financial results. I'll then review some geographic highlights and discuss a few key announcements this quarter. Finally, I will hand over to Brett, who will walk you through our financial results in more detail.

We achieved solid high single-digit global revenue growth this quarter, led by sales of our sleep devices, respiratory care devices, mask systems and software solutions. At the bottom line, on a non-GAAP basis, our diluted earnings per share was $0.77.

We have passed the 1-year mark since the closing of our Brightree acquisition. That acquisition has been a significant success for homecare customers, for patients and for shareholders.

This quarter, we acquired new capabilities and technologies to add to our Brightree offering with 2 tuck-in acquisitions that I will go into further detail on later on in the call.

We're making great progress with Brightree as we expand our connected care offering for all of our customers, lowering costs and freeing up cash flow that can be reinvested for even better patient care. I'll discuss more details of our digital health and connected care strategy later in my remarks.

We have refined our operating model at ResMed to ensure a direct line from customer insights through upstream marketing to our product and solution development teams and also a direct line back down to the sales interface within each of our vertical businesses. You can think of this as a merging of what were regional sales structures into global business units. We now have a global sleep business vertical, a global Respiratory Care business vertical and a global Software-as-a-Service business vertical.

We have also maintained a direct line from Rob and me to our Asia growth markets business and our Germany health care business due to the unique go-to-market models of these 2 businesses.

With this refined operating model, we will not only improve our innovation generation capability. We will also be able to scale more efficiently and provide better SG&A leverage as we grow towards our 2020 financial and strategic goals.

Now for some geographic highlights of the business. The Americas sales teams achieved solid revenue growth at 8% year-on-year or 6%, excluding Brightree. These results were fueled by solid growth in devices as well as double-digit -- low double-digit software sales growth.

Sleep apnea patient volume is growing steadily. We launched the world's smallest CPAP, which is now my favorite business travel companion, called the AirMini. Since its launch around mid-May, the AirMini is achieving good early adoption in its product category of small, second-use, travel-friendly, cash-pay CPAP and APAP devices. I'll talk about AirMini in more detail a little later.

Growth in devices in the Americas geography was a solid 8% for the quarter. We continue to grow our device market share as homecare providers and physicians find value from AirView software and our fast-growing patient engagement app called myAir. We now have over 5 million patients in AirView and over 3 million patients monitored daily with 100% cloud-connected medical devices in their homes.

We also achieved very good growth of our Respiratory Care device platforms in the U.S., led by the Astral cloud-connected life support ventilator.

The masks and accessories category grew 4% in the Americas geography this quarter. As we noted on our call 90 days ago, we expected to have mask supply constraints throughout the first half of the quarter and to get our manufacturing sufficiently ramped up so that we would be ahead of demand and have supply ahead of demand by June. We did just that. However, we clearly missed out on some perishable mask sales of product in April and May, while the N20 and F20 were in limited availability.

Now we have supply solidified, and we can instill importantly full confidence in our sales force that when they make a sale, we can deliver the N20 and F20 products to fulfill that commitment. We are now set to increase sales growth in masks for FY '18 as we unleash our sales force with these excellent products and full supply.

In terms of customer feedback on the N20 and F20, it remains very positive. The 97%-plus fit range and the comfort of the InfinitySeal technology provide a very long runway of growth throughout fiscal year 2018 and beyond.

Let's spend a few minutes now reviewing our European and Asia geographies. Device sales in the combined EMEA and APAC regions were up a very strong 11% this quarter on a constant currency basis. Growth was particularly strong in France, the U.K., Japan as well as Australia and New Zealand.

It is worth noting the reimbursement for telemonitoring has been approved now in France. This has provided and will provide on an ongoing basis increased adoption of the Air Solutions ecosystem, including the AirSense 10 and the AirCurve 10 device platforms as well as AirView and myAir software platforms.

Digital health and connected care are going global, and ResMed is a catalyst for that. We have had excellent success with connected care value creation for our U.S. customers these last 3-plus years, and we expect to continue that. But now we also expect to provide similar value creation from connected care for our customers in Europe and across Asia Pacific as we expand this offering.

We also achieved solid growth in our dental business in Europe with the Narval mandibular repositioning device.

Masks and accessories grew at 4% this quarter in combined Europe and Asia geographies. Similar to the U.S. commentary, we expect this growth to expand in FY '18 based on the positive feedback from patients, physicians and homecare providers. Customers in Europe and Asia are also excited by the broad fit range and enhanced comfort of the AirFit N20 and the AirFit F20.

Let me now take a few minutes to update you on progress against each of the Three Horizons in our 2020 growth strategy, and then I'll hand the call over to Brett.

In the first horizon of growth, which focuses on our sleep apnea business, we're making significant advances with the smallest, the quietest and the most comfortable products enhanced by digital health and connected care. We launched our new AirTouch full-face mask in the U.S. during the fourth quarter. The AirTouch UltraSoft memory foam cushion is a breakthrough in the treatment of sleep apnea. AirTouch is the softest CPAP mask in ResMed's history. It is a significant innovation that is truly novel and very patient-friendly. This mask addresses the #1 reason that patients quit CPAP therapy, which is comfort. The UltraSoft memory foam is permeable, allowing heat and moisture to escape without compromising therapy pressure. The AirTouch foam mask cushion also fits into the AirFit F20 frame, giving our homecare customers interchange and switch options as they fit patients and help patients better adhere to CPAP therapy.

As we discussed earlier, we started shipping the world's smallest CPAP midway through May. It is still very early days, but we have had excellent initial demand for the AirMini, and we are expanding and leading in this new niche product category. There is solid demand for a category of small, travel-friendly, second-use CPAP devices that patients are willing to buy with their own cash. You will hear more from us as we build this category and drive growth with AirMini.

We continue to lead in the field of connected care, one of the key foundations of our growth strategy. This quarter, we announced 2 tuck-in acquisitions within the Brightree product portfolio that enhance existing Brightree modules and address customer pain points for order intake and opportunities in resupply.

The first acquisition of a technology called Conduit Office is the technology behind the Brightree module called MyForms. This technology will allow us to enhance MyForms as a leading documentation and workflow management solution. MyForms provides automation to help improve the order intake process of our homecare customers. The net result is reduced claim denials and improved audit outcomes for homecare customers.

The second tuck-in acquisition is a company called AllCall Connect. This acquisition provides a full-featured live call center for homecare customers who subscribe to Brightree Connect, one of our resupply offerings. It can be expensive and sometimes inefficient for homecare customers to develop their own in-house live calling resupply capability. However, we know from our research that regular CPAP mask and accessory replacement are critical to ensure ongoing patient comfort, fit and adherence to CPAP therapy. AllCall Connect allows us to provide this service to our customers.

On the big data to actionable information front, a new study was presented at the American Thoracic Society conference in May. This ResMed-sponsored study of over 130,000 patients on PAP therapy showed that patients with treatment-emergent central sleep apnea, or CSA, are 2x more likely to terminate therapy. This study highlights the importance of monitoring patients to support adherence. Also, it shows that early diagnosis of CSA and use of therapy, such as ResMed's ISV technology, may minimize risk of therapy non-adherence.

The de-identified aggregated propensity matched data in the study leveraged the more than 1 billion nights of sleep data in our connected care digital health ecosystem.

With our new Chief Medical Officer, Dr. Carlos Nunez partnering with global teams of researchers in digital health, we predict that the insights gained from studies like this and beyond will provide the opportunity for ResMed and our partners to advance the field of sleep medicine faster than ever before.

Moving to the second horizon of our ResMed 2020 growth strategy. Our cloud-connected noninvasive ventilators and life support ventilators continue to grow globally. And we continue to develop our connected care strategy within COPD. The Journal of Global Health estimates that there are over 380 million patients worldwide suffering from chronic obstructive pulmonary disease. With COPD being the #3 cause of death and the #2 cause for rehospitalization, we are focused on testing and driving models that lower costs and improve outcomes for COPD patients. This is an urgent need to address a growing public health crisis.

On the clinical front, a study using a combination of home oxygen therapy and home mechanical ventilation, a study known as HOT-HMV, was published in the Journal of American Medical Association or JAMA. This ResMed-sponsored study was presented at the American Thoracic Society in May and was previously presented at ERS. The conclusion of the study is that patients who received noninvasive ventilation at home, in addition to oxygen therapy at home, had a 51% decrease in the risk of rehospitalization or death. This major finding is now published in the peer-reviewed press in a top-tier journal. This is an important milestone.

HOT-HMV contributes to a growing body of evidence supporting the broader use of noninvasive ventilation, such as ResMed's AirCurve 10 platform, as an important treatment for patients with COPD. We are excited that we now have our global respiratory care business vertical, including direct line of sight from management down to the sales interface.

This all bodes well for better leverage of studies like HOT-HMV to drive changes in standard of care and drive further growth of noninvasive ventilation, portable oxygen concentrator and life-support ventilation businesses.

Our third horizon of growth includes a portfolio of opportunities, including sleep health and wellness, chronic disease management as well as out-of-hospital Software-as-a-Service business models. We are working with payers and providers to develop and enhance chronic disease management algorithms, including population health models, care coordination models as well as to acquire and grow Software-as-a-Service models for home health, home nursing and hospice verticals.

We made progress during the quarter in this area with Brightree's new offering for the home health and hospice market, a solution called OASIS, which stands for Outcome and Assessment Information Set. This is an integrated software and service solution with Brightree's coding and billing service that helps home health and hospice agencies reduce errors, improve patient care and optimize reimbursement, saving time so that they can focus on patients. This continues to be an exciting area for us as we look for ongoing growth of our software offerings.

Let me close with this. We are incredibly excited about our new product launches this last fiscal year and during the quarter with the N20, the F20, AirTouch full-face masks and the world's smallest CPAP, the ResMed AirMini. We are well positioned for fiscal year 2018, and we continue to work on a pipeline of new products and connected care solutions for sleep apnea, COPD, neuromuscular disease and other clinical adjacencies.

We are positioning the company for long-term growth for 2020 and well beyond as we refine our operating model, better enabling customer insights to power our product and service solutions team's developments and then drive even better sales execution.

We continue to bring our strategy into action for the benefits of physicians, providers, payers and, most importantly, to improve the lives of tens of millions of sleep apnea and COPD patients around the world.

With that, I'll turn the call over to Brett for his remarks, and we will go to Q&A after that. Over to you, Brett.

Brett A. Sandercock - *ResMed Inc. - CFO*

Great. Thanks, Mick. In my remarks today, I'll provide an overview of our results for the fourth quarter of fiscal year 2017.

As Mick noted, we had a solid quarter. Group revenue for the June quarter was $556.7 million, an increase of 7% over the prior year quarter, or in constant currency terms, revenue increased by 8%.

Taking a closer look at our geographic distribution and excluding revenue from Brightree, our sales in the Americas were $314 million, an increase of 6% over the prior year quarter. Sales in combined EMEA and Asia Pacific totaled $206.5 million, an increase of 6% over the prior year quarter. Or in constant currency terms, sales in combined EMEA and Asia Pacific increased by 9% over the prior year quarter.

Breaking out revenue between product segments. Americas device sales were $174.4 million, an increase of 8% over the prior year quarter. Masks and other sales were $139.6 million, an increase of 4% over the prior year quarter. The revenue in combined EMEA and Asia Pacific, device sales were $145.4 million, an increase of 9% over the prior year quarter or, in constant currency terms, an increase of 11%.

Masks and other sales were $61.1 million, an increase of 1% over the prior year quarter or, in constant currency terms, an increase of 4%.

Globally, in constant currency terms, device sales increased by 9%, while masks and other increased by 4% over the prior year quarter.

Brightree revenue for the fourth quarter was $36.2 million, with growth on a prior year comparable basis continuing to track in the low double digits.

During the rest of my commentary today, I'll be referring to non-GAAP numbers. The non-GAAP numbers in the current quarter adjust the impact of amortization of acquired intangibles. In the prior year comparable, they exclude amortization of acquired intangibles, acquisition-related expenses, Brightree onetime deferred revenue, fair value adjustment, SERVE-HF accrual release and a cumulative tax benefit associated with the adoption of accounting standard ASU 2016-09.

We have provided a full reconciliation of our non-GAAP to GAAP numbers in our fourth quarter earnings press release.

Our gross margin for the June quarter was 58.2%, consistent on a year-over-year basis. This reflects manufacturing and procurement efficiencies, offset by declines in average selling prices and changes in product mix.

Assuming current exchange rates and likely trends in product and geographic mix, we expect gross margin for fiscal year 2018 to be broadly consistent with our Q4 FY '17 gross margin.

Moving on to operating expenses. SG&A expenses for the quarter were $147.9 million, an increase of 10% over the prior year quarter or in constant currency terms, SG&A expenses increased by 11%.

SG&A expenses as a percentage of revenue were 26.6% compared to the 25.8% that we reported last year.

Looking forward, and subject to currency movements, we expect SG&A growth rates to moderate over the course of fiscal year 2018. As a result, we expect SG&A as a percentage of revenue to improve from around 27% at the beginning of fiscal year to around 26% by the end of the fiscal year.

R&D expenses for the quarter were $36.7 million, an increase of 7% over the prior year quarter or, on a constant currency basis, an increase of 6%. This increase reflects incremental investments across our R&D portfolio.

R&D expenses as a percentage of revenue was 6.6%, consistent with the prior year.

Looking forward, and subject to currency movements, we expect R&D expenses as a percentage of revenue to be in the range of 7% to 8% for fiscal year 2018.

Amortization of acquired intangibles was $11.8 million for the quarter, a decrease of $900,000 over the prior year. Stock-based compensation expense for the quarter was $11.7 million.

Non-GAAP operating profit for the quarter was $139.1 million, an increase of 3% over the prior year quarter, while non-GAAP net income for the quarter was $109.6 million, an increase of 5% over the prior year quarter.

Non-GAAP diluted earnings per share for the quarter was $0.77, an increase of 4% over the prior year quarter, while GAAP diluted earnings per share for the quarter was $0.71.

Additionally, foreign exchange movements negatively impacted fourth quarter earnings by $0.03 per share, reflecting the unfavorable impacts from the weaker euro and the stronger Australian dollar relative to the U.S. dollar.

On a non-GAAP basis, our effective tax rate for the quarter was 17.8%, and for the fiscal year 2017, it was 20%.

The current quarter effective tax rate was favorably impacted by a tax benefit of $2.2 million, based out of a share-based payment transactions recorded in accordance with accounting standard ASU 2016-09.

Looking forward, we estimate our effective tax rate for fiscal year 2018 will be in the vicinity of 22%.

Cash flow from operations was $140.3 million for the quarter, reflecting strong underlying earnings and only a modest increase in working capital balances. Capital expenditure for the quarter was $18.4 million, while depreciation and amortization for the June quarter totaled $28.2 million.

Our Board of Directors today declared a quarterly dividend of $0.35 per share, an increase of 6% over the previous quarterly dividend.

As previously announced, we have temporarily suspended our share repurchase program due to recent acquisitions. However, we expect to recommence our share buyback in the second quarter of fiscal year 2018.

As a minimum, the aim of the buyback will be to offset the dilution impact from employee equity grants. This is estimated to be in the range of 1 million to 1.5 million shares annually.

At June 30, we had $1.1 billion in gross debt and $257 million in net debt. Our balance sheet remains strong with modest debt levels. At June 30, total assets were $3.5 billion, and net equity was $2 billion.

And with that, I will hand the call back to Agnes.

Agnes Lee - *ResMed Inc. - Vice President, Investor Relations and Corporate Communications*

Thanks, Brett. We will now turn to Q&A. (Operator Instructions)

Mariama, we are now ready for the Q&A portion of the call.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Margaret Kaczor from William Blair is on the line with a question.

Scott Schaper

This is actually Scott on for Margaret. I wanted to start on the U.S. market growth for both devices and masks. Mick, should we look at device growth on a 6-month basis? Or is underlying device growth accelerating in the U.S.? And then on masks, how did that underlying market growth compare to Q -- compared to last quarter in Q4?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Thanks for the question, Scott. In terms of market growth, I think it's always good to look at a 6-month or even 12-month trailing period because there's lots of sort of fluctuations that can happen on a quarterly basis, seasonally adjusted and aspects of how the market may turn. In general, we look at the market as mid- to high single digits growth for the market. And devices are at the low end of that range. And masks are at the high end of that range. At ResMed, we like to not just meet but beat market growth rates. And I'd say, if you look at this quarter, completely, we beat market growth rates with our device growth, and we're a little behind it on our mask growth rate, given some of the supply constraints in the first half of the quarter. But the market growth rate, I think it is good to look at a 6- or 12-month trailing period to sort of get a better picture of what the market growth is.

Scott Schaper

Okay, great. And then Brett, I want to ask on gross margin in the quarter and then the puts and takes of that number in terms of currency and mix and pricing. And you guys guided to the gross margin for the fiscal -- for next fiscal year to be consistent with this quarter. The same kind of question in terms of headwinds and tailwinds concerning you guys probably have a pretty strong mask growth rate throughout the year.

Brett A. Sandercock - *ResMed Inc. - CFO*

Yes. I mean, on the -- well, as you said, Scott, lots of puts and takes on that, but I guess the margin is -- if you look it over the last few quarters, relatively stable in that sense. And we're seeing certainly sort of moderation and that product mix impact is still there. A little bit negative. We still had -- we had really strong device growth. So obviously, if devices are growing more strongly than masks, then you have a slightly negative impact on margins. But to the extent, we get -- we see some improvement in that mask growth through FY '18, then that would certainly be supportive of product mix and supportive of the gross margin.

Scott Schaper

Okay. And then lastly for me, kind of a bigger-picture question on AirMini. Could this potentially be something you push as more of a mainstream product or something you would consider investing DTC advertising dollars towards? Or are you guys just going to rely on kind of your traditional customers to promote the product themselves?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes, thanks for that question, Scott. Look, the AirMini is a really exciting product, and it's the world's smallest CPAP. But it is designed to be a second-use, cash-pay, travel-friendly device, and that's sort of the niche segment category, if you like, that it's creating and growing and leading. We've seen great initial demand in the U.S. through our homecare channel as they get the opportunity to enhance their cash sales. And in markets around the world where there are other go-to-market models, patients are willing to pay out-of-pocket. And I think there was some good pent-up demand for a travel-friendly CPAP like this, and we explored -- we look forward to expanding that niche category to a larger niche and continuing to lead it. And the AirMini technology is doing great job on that.

Operator

Sean Laaman from Morgan Stanley is online with a question.

Sean M. Laaman - *Morgan Stanley, Research Division - Australian Healthcare Analyst*

Just to re-ask the question, Brett, on gross margin. I mean, if the feedback on -- if the mask is good as what the feedback suggests, I'm not really sure why we don't really see a meaningful tick up in mask growth, and therefore, why wouldn't we see some upward pressure on gross margin.

Brett A. Sandercock - *ResMed Inc. - CFO*

Well, in that sense, we would, Sean. I guess, what I'm saying at the moment is it's broadly consistent. We're still seeing some pretty good device growth. Again, we expect to see better growth in masks than what we saw this quarter. And to the extent we see that coming through, then I'll update gross margin guidance in a dynamic way. So we'll still continue to update as we go. And it's the same story. If we do -- we get the acceleration in mask, then you'll see some improvement in gross margin. But we're still doing pretty well in devices also. And year-on-year, we've had a few -- if you look at the FX and things like that year-on-year, it was a little bit of a headwind for us as well. So there's a few things playing out on that. I don't -- I mean, the thesis still holds. If we get good mask growth, then you'll see an improvement in product mix and an improvement in gross margin.

Operator

(Operator Instructions) David Low from JPMorgan is online with a question.

David A. Low - *JP Morgan Chase & Co, Research Division - Research Analyst*

If we could just touch on the device growth because you say there's good strong results there. Just wondering if you could give us some sense as to what sort of contribution you saw from the noninvasive ventilation line, if it -- was that growing strongly. And was the Mini device much of a contributor to that [margin], please?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Hey, David, it's Mick here. As you know, we don't split out our respiratory care device growth versus sleep device growth at this point. But look, what I can say qualitatively is that the vast majority of that growth was the sleep apnea device growth, powered by the AirView software solution and uptake of the great value for physicians and providers from AirView. But that is, as we move connected care over to our respiratory care platform, that is bound to get some momentum there. I will say that AirMini coming out the gates was relatively minimal on its impact on the aggregate device growth because that niche is really just starting up. But it was in balance between sleep apnea and respiratory care growth but heavily weighted towards sleep apnea device growth, particularly in the U.S. region in terms of the year-on-year growth there.

David A. Low - *JP Morgan Chase & Co, Research Division - Research Analyst*

Great. And sorry, just a related question. I mean, the French change, so the telemonitoring, was that meaningful in this quarter? Or is that something that's likely to become more of a contributor going forward?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes, that's more of an ongoing contributor. It will have some influence on product selection by customers as they are looking to make purchases during those 90 days. But it -- that changes something that is actually changing the fundamental basis of competition, if you like, in the industry in France. And it's an ongoing opportunity for us to drive AirSense, AirCurve and really the whole Air Solutions ecosystem, particularly the software side of AirView. And we're seeing the French physicians really embracing the technology, and we're seeing French customers really liking the efficiencies that they can get from the technology. And we're looking forward to patients getting the ability in France to get access to myAir data and at the same levels that the patients throughout the U.S. have these last 3 or 4 years. And we think the value across that whole ecosystem of customers will be strong. So the short answer is, it's an ongoing thing. And it did impact a little bit in the quarter, but it will be ongoing for FY '18 and beyond.

Operator

Saul Hadassin from Credit Suisse is online with a question.

Saul Hadassin - *Credit Suisse AG, Research Division - Director*

Can I just to check regarding just the Brightree commentary in terms of growth. If I go back to the 4Q '16, and just look at revenues there, it looks like growth, implied growth is about 25% this quarter. Can you just clarify whether that was the case? And was there any contribution from some of those tuck-in acquisitions you made?

Brett A. Sandercock - *ResMed Inc. - CFO*

Yes. So that's right. It was a little bit complicated last year with the fair value adjustment that we had from Brightree around the acquisition and on the revenue side and a few -- like it was a slightly shorter quarter. So what I've done and what I've said for that is really an underlying prudent comparable growth rate. If you look at like-for-like just on the numbers that we've got in our filings, for example, you're exactly right. It's around that 25%. But if you look at it on a pure comparable basis, [or] just try to strip out some of those sort of adjustments, then we're looking at that pretty solid low double-digit growth.

Saul Hadassin - *Credit Suisse AG, Research Division - Director*

Can I just ask one additional question about the impact of currency for fiscal '18 on gross margin as -- in terms of where currency stands at the moment? Is there net benefit coming through this fiscal year based on what the euro has done versus the USD? Or is that effectively offset by the rising Aussie dollar on the COGS side?

Brett A. Sandercock - *ResMed Inc. - CFO*

Yes, you're right. If I have a look, just to give you a sense for it, if I look at currencies, they're moving around a lot lately, as you've been aware. But if I look at it going into -- sequentially going into Q1, and I think we'd get a benefit of some -- I currency at the moment, I think we're looking to get a benefit of maybe sort of that 20 to 30 basis points. But then if I take it into Q2, where we then start to pick up some of the impact from the appreciating of the dollar, it basically reverses that. It's basically a roughly 40 basis point reversal. But it's a little bit of a tailwind sequentially going into Q1 and then turns into a small headwind into Q2. And then going forward, that should then just sort of flatten out. But if you look at it sequentially there, that impact is better in Q1 but then a worse impact in Q2 for us. And that's really driven off that pretty sharp increase in the Aussie dollar, which just happened quite recently. And then we'll see where that heads. But at the moment, that's the impacts that we're looking at.

Operator

Joanne Wuensch from BMO Capital Markets is online with a question.

Joanne Karen Wuensch - *BMO Capital Markets Equity Research - MD and Research Analyst*

Two questions. The first one is, it's great to hear that you're out of supply constraint on the masks and the accessories or the 2 new mask items. Can you give us an idea of where do you go from here with full supply? What kind of demand that you're seeing for those products?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes. Look, I think the demand is high. The physicians like it because it's broad fit range. Technicians like it because -- most importantly, patients like it. And it has a good first time fit ratio and a very broad fit range at 97% on one and a 99% on the other. And the InfinitySeal comfort technology, just having very light levels of plastic around the bridge of the nose is very comfortable for patients. So we missed some perishable sales in the first half of the quarter due to supply constraints. That goes away in Q1, right. As we look forward to FY '18, our sales force confidence will really be there. And I think that's a part that you shouldn't underestimate that when sales people aren't sure of supply, they don't sell that product line. And when they are sure of supply, they can sell that product line. So as we look forward to FY '18, we think there'll be some very good success in the N20 and F20. And I'm really happy to let that sales team do what they do best, which is provide that value to customers in a way that they can help give it to their customers who are the patients.

Joanne Karen Wuensch - *BMO Capital Markets Equity Research - MD and Research Analyst*

Is there a way to quantify those lost perishable sales?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

There are probably 20 different models that we have internally, but it's not something we talk about externally. It's certainly something that, as we said 90 days ago, we never like to be under supply constraints. With innovation, new technologies, new plastics, new ways of designing single-cushion masks that revolutionize the market, we had some challenges with the technology there last quarter. But the good news is we're through that. And as we look forward, we're looking to continue growth and particularly growth in masks.

Joanne Karen Wuensch - *BMO Capital Markets Equity Research - MD and Research Analyst*

Excellent. And then my second question really is just operating margins. They compressed year-over-year on a higher SG&A. Do you see sort of this new annual run rate as a steady-state? Or should we start moving up from here with the higher mask margins?

Brett A. Sandercock - *ResMed Inc. - CFO*

Yes. I mean, on operating margins, Joanne, yes, we've guided sort of broadly consistently on the gross margin. We've answered that around how do we get through FY '18 improving that mask growth and so on. That's going be supportive for gross margin. Then on the operating margin side, I do -- we expect it will get to moderation in SG&A growth rates. Things such as legal costs and so on are hurting us -- have been hurting us through FY '17. As we work through FY '18, we're focused on driving some operating leverage, and we expect to improve that over the course of FY '18. And to the extent we do that, then that will drop through to the bottom line.

Michael J. Farrell - *ResMed Inc. - CEO & Director*

What I'd add to that, I think, is as we look to drive operating leverage on a longer-term basis and moderate SG&A as a percentage of revenue, I think we can get more aggressive in how we'd scale our business. And as I said in the prepared remarks, Joanne, we've refined our operating model with business verticals that include the sales force and marketing teams, downstream marketing teams in region and in countries. And I think there's a lot of opportunity for us to grow revenue significantly faster than we grow our SG&A as we look forward to 2020 and well beyond. So short term, I agree with Brett. We've got some refinements and great capability to drive operating leverage, but longer term, that could be even better.

Operator

Will Dunlop with Bank of America is online with a question.

William Dunlop - *BofA Merrill Lynch, Research Division - VP in Equity Research*

Just again, I wanted to ask about the gross margin and perhaps why you didn't provide a range for the guidance. That guidance seems quite specific, even though there's probably quite a bit of variability in the product mix that could occur and geographic mix that could occur throughout fiscal '18.

Brett A. Sandercock - *ResMed Inc. - CFO*

You're right, Will. I mean, there always going to be variability. There's a number of factors that play out. I mean, I'll just -- you mentioned a few of them, but you've got the interplay of ASP, procurement, manufacturing improvements, FX, product mix, geographic mix. There's a bunch of factors that play out on that side, so that is difficult to predict, I guess. But I think, broadly consistent. I mean that easily, you can see that as being not -- I don't think of that as being like purely consistent.

But I think there's -- you could see that -- you can argue that's a bit of a range anyway around where we're at. So it certainly can be, and we've talked about it already, an improvement in masks and so on can mean that we can get some expansion in gross margin. So I didn't mean that to be a really precise, measurable guidance. I think you could range around that 58.2% as well.

William Dunlop - *BofA Merrill Lynch, Research Division - VP in Equity Research*

Okay, great. And secondly, just on the SG&A as a percentage of sales guided to be declining through fiscal '18. Is that because you expect litigation costs to roll off? And if not, are they going to be a material component of SG&A for fiscal '18?

Brett A. Sandercock - *ResMed Inc. - CFO*

Well, I mean, we're still going to -- we still have litigation costs and they'll still be coming through FY '18. But we did ramp up through FY '17, I guess, and that was hurting our growth rate on SG&A. We do think, yes, in terms of litigation, it's hard to predict exactly where that will end up. But I think it will be not sort of accelerating in terms of our growth from when we were in FY '17. But we'll continue to be spending money on legal expenses around litigation. But I think it's more broader than that in terms of moderating SG&A growth rates. So it's not just about legal costs bubbling out or going down or whatever that might be. It will be more broad-based than that. And I should say that guidance as well is notwithstanding pretty sharp appreciation in the Australian dollar, which we got a lot of operating costs in Australian dollars. So we're going to deal with that as well. So obviously, that's going to be a little bit of a headwind through FY '18, but we remain confident that we can moderate the SG&A growth through FY '18, notwithstanding currency impacts.

Operator

Andrew Goodsall from UBS is online with a question.

Andrew Goodsall - *UBS Investment Bank, Research Division - MD and Senior Healthcare Analyst*

I'm just coming back to, I guess, how you traded across the quarter particularly with masks. I know you belabored this a little bit -- or we belabored it a bit. Just trying to sort of understand when the back order came off, and when we look at that mask number, if we're sort of looking at really a sort of a 1-month effect of full availability. And I guess, just trying to understand the exit rate to give us some confidence around '18.

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes, Andrew. So as I said, we were supply-constraint through well beyond halfway through the quarter. So you can sort of look at it as yes, 4 to 5 weeks of the supply constraint starting to go away SKU by SKU and us getting supply ahead of demand. I think the fact that I talked a little a bit to earlier, Joanne's question, with regard to sales force having full confidence that they're going to have supply, it's not -- that's not binary. You don't just on Monday morning say, "We've got full supply," and the sales force says, "Fantastic. I'm going to go and sell a truckload of F20s." I think what it takes is some time, and they make some small orders and make sure it comes through and then ramp up because they're intelligent sales people that have very good relationships with their customers. They want to fulfill those relationships with when they make a sale that we can deliver the order. I think what we've shown in the last 4-plus weeks of the quarter is that we were able to deliver on all those sales. And so I think the exit rate from Q4 was very strong from our team in terms of what they're able to provide to customers for N20 and F20. And I expect that to continue very strongly in Q1 and throughout FY '18 as we are completely supply non-constrained and the sales force can be really out there driving the full bag of products that ResMed has for our customers, which is a really strong portfolio right now.

Andrew Goodsall - *UBS Investment Bank, Research Division - MD and Senior Healthcare Analyst*

That's great to hear. Actually right now, I guess, maybe without answering my own question, I guess, just obviously, the old stock does have a pretty intense replenishment schedule or monthly, so I guess it's fair to say no real effect of that in this quarter. I mean, that sounds like it's sort of a next quarter event?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes. The AirTouch range with the foam masks does have a faster replacement cycle. It's incredibly comfortable. Heat and moisture can be removed, but air pressure stays high. But it does have a faster replacement cycle. Yes, I mean, we've really started launching that mid-May. And so we got very little, if any, replacement cycles on the AirTouch. And that whole category of a foam mask with a different replacement cycle, having intense comfort is really the category that we're developing over time. I don't know, Jim, who's head of our sleep business and running the Americas, last quarter, you want to give any further insights to AirTouch?

James Hollingshead - *ResMed Inc. - President of Americas*

Yes. I think we're confident in all 3 masks. The F20 and N20 are both on great trajectories. And now that we're off supply-constraint, we're very confident in forward growth in Q1 and throughout the year. AirTouch would start later, launch later. It's getting fantastic reviews from both physicians and patients. And you're absolutely right. We're not yet really into -- it didn't launch early enough for us to see any real impact on resupply on the cushions in the quarter.

Operator

Steve Wheen from Evans & Partners is online with a question.

Steven David Wheen - *Evans & Partners Pty. Ltd., Research Division - Senior Research Analyst*

Just a question on Brightree. We haven't had an update in the gross margin of that business since you first acquired it. And I just wonder how that might look today, particularly in light of some of the acquisitions that you've made.

Brett A. Sandercock - *ResMed Inc. - CFO*

Sure, Steve. It's Brett. Yes, I mean, look, they're pretty consistent with those we disclosed at the time we made the acquisition. So there's really no material difference on those margins. We've got a couple, but they're kind of like small tuck-in acquisitions, I guess. They're not -- these are not enough to move in any significant way the operating margins at Brightree, so they've been pretty consistent through that period since acquisition.

Steven David Wheen - *Evans & Partners Pty. Ltd., Research Division - Senior Research Analyst*

Yes, okay. And then just with the R&D guidance, that looks like it's stepping up a bit in 2018. Is that -- is there anything you can talk to on the R&D front that might be driving that other than currency?

Brett A. Sandercock - *ResMed Inc. - CFO*

Yes. Well, currency is a pretty big one. So I mean, the 2 things is we'll continue to invest in R&D, so we're going to continue to do that. So we'll continue to grow our investment there. And the second one that's probably burning us a bit on that on the guidance or basically I'm looking at 7% or 8% is really the uptick. I'm looking at this Aussie dollar. And a lot of our R&D is still done in Sydney and in Australian dollars. So that hurt us. If I look at the forecast, that hurt us a bit on the R&D, just in R&D, in terms of U.S. dollars. So those are 2 factors that have led us to guide around that 7% to 8% mark for FY '18.

Steven David Wheen - *Evans & Partners Pty. Ltd., Research Division - Senior Research Analyst*

Yes, okay. And then just one other. Could you just give a bit more color around the effective tax rate? It's just even without the change around the accounting standard, it looks a lot lower than what I was expecting. Yes, if you could just address that, that would be great.

Brett A. Sandercock - *ResMed Inc. - CFO*

Yes, I can. I mean, the overall for the year, Steve, the quarter will be hard because anything you do in terms of year-end calculation of tax, everything gets sort of concentrated into the last quarter. But if you look at full year, we're around 20%. And that was probably helped a little bit by the ASU 2016-09 accounting standard. So that's sort of contributing a little bit there. Perhaps, underlying, it's more like 21% or something like that. So that's sort of where we'd landed in underlying rate. If we look at it going forward, it's just -- I'll uptick that a little bit with just around looking forward around the geographic distribution of taxable income is, a factor the stronger Australian dollar is going to be a factor on that, at least [it will be] contributing a little bit. And a few other things such as the R&D tax concession in Australia, which is capped at $100 million. And it's reduced from 40% to 38.5%. So a number of those factors is sort of playing out on the tax rate and has led us to increase that just a little bit from where we were in FY '17.

Steven David Wheen - *Evans & Partners Pty. Ltd., Research Division - Senior Research Analyst*

Right. Can I ask just one more? Just the other income line, that reverses from the profit to a loss. Is that just hedging? Or is there anything else in there?

Brett A. Sandercock - *ResMed Inc. - CFO*

Yes, that's predominantly FX losses through hedging.

Operator

Victor Windeyer from Citi is online with a question.

Victor Windeyer - *Citigroup Inc, Research Division - VP and Analyst*

Look, I just wanted to ask about the portable oxygen concentrator business. As far as my sense is, that hasn't sort of grown. And it's been a little disappointing. But what's your sort of take on where that business is going and how you can sort of really drive growth there? Because it looks like a good opportunity.

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes, Victor. I'll hand that to Rob Douglas to talk about POCs.

Robert A. Douglas - *ResMed Inc. - President & COO*

Thanks, Victor. Victor, we have continued to work hard on the Activox product, and we've actually made a number of improvements under the hood, so to say, of the device. And we've seen a lot of improved performance. And we think that -- I think we've done a great job on that improved performance. And now we're just sort of getting that through to the customer base. But we're not re-branding yet. We're still waiting for further improvements that we think -- and you know we're happy with the devices when ResMed puts its brand on it. So today, we're still work in progress. We're making very good progress. The Activox unit remains a very good, very light, very long battery life device. And our teams are promoting it appropriately to key customers. So we're in it for the long haul, and we believe it's going to be a very good business.

Victor Windeyer - *Citigroup Inc, Research Division - VP and Analyst*

Okay. And do you think, I mean, in terms of the ResMed branded product, are you well down the path in terms of development of that, Rob? Or is that something you're after?

Robert A. Douglas - *ResMed Inc. - President & COO*

Victor, one of the things we've learned out of these, we really can't forecast our R&D program. It's just too good for competitors and everyone like that. So we're really reluctant to give you a time line and details on that.

Victor Windeyer - *Citigroup Inc, Research Division - VP and Analyst*

Yes, okay. And does this form part of this new -- I mean, it sounds like you're sort of doing a slight reorganization to the operations with these new business verticals. Is this -- presumably, this falls into the Respiratory Care part of that business. Is that right?

Robert A. Douglas - *ResMed Inc. - President & COO*

Yes. Victor, we've got a very strong Respiratory Care team that's able to focus on getting and treating patients with respiratory insufficiency, or COPD. It's one of the main patient conditions that we're aiming to treat. We've got an improving and an emerging portfolio of treatment options there. We'll be building more of them. As Mick mentioned earlier, we've really generated lines of business where we've got much closer engagement between our sales organization and our customers back through to our R&D teams. We should, over time, see benefits on the R&D programs for that.

Operator

Matt Taylor from Barclays is online with a question.

Matthew Charles Taylor - *Barclays PLC, Research Division - Director*

First one I wanted to ask was just about the acquisitions. I know they're tuck-ins, but could you help us understand whether there was any contribution in the quarter and what you're expecting from those in terms of contribution in the next fiscal year?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Thanks for the question, Matt. No, there was deminimis contributions in Q4 from those tuck-in acquisitions. They're really about technologies that will enhance our ongoing future growth of the Brightree offering. So to maintain and grow that double-digit growth of high-margin business and Software-as-a-Service, we're finding tuck-ins of some good technologies can really help enhance that growth and drive further value for our customers. So AllCall Connect, I met the team. They're actually with me up in Halifax with our health care informatics team. We have, straight off the acquisition, already engaged with our software development teams and really starting to say, "Well, how do we link this tuck-in technology with all the great offerings we currently have on Brightree and continue to provide that value as we go forward?" So the short answer is no contribution Q4 '17. We expect great contributions as that capability of AllCall and Conduit Office roll into the offerings from Brightree, some particular modules that will expand over FY '18, '19 and beyond.

Matthew Charles Taylor - *Barclays PLC, Research Division - Director*

Okay. And just a question on leverage. I mean, if I look at your guidance quite literally, it would imply a slight negative leverage in fiscal '18. I know you have a headwind from foreign exchange, but what are the other headwinds that you have that maybe we're not thinking about? And how can you get more leverage out of the business as you continue to grow the top line?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes, Matt, look, it's a great question. And clearly, we are looking for operating leverage. And you can't control things like FX. And those just have to be budgeted where they are now. Where they will be, who knows? We will see as those move. But the things you can control, your SG&A growth, your R&D growth, your investments across your portfolio and how you go to market. As I said in the prepared remarks, establishing these new business verticals, rolling sales into global businesses, we think there's a lot of efficiency we can gain in how we grow revenues significantly faster than growing SG&A while providing the same or even better value to customers. So it's something that we're laser-focused on in terms of operating leverage getting SG&A leverage and driving that growth. We're not going to grind out R&D dollars and not invest in innovation. I mean, that's something we're going to continue invest at a very strong rate. We put that sort of 7%-plus guidance in there and FX might tick that up to 8%. But SG&A can come down from 27 to 26 and below because there are great ways to scale marketing through social media and digital marketing. There are great ways to scale our sales force and how we go to market in different countries. And so we've got a lot of very exciting plans for the next fiscal year and beyond in terms of driving our go-to-market strategy that I very strongly believe will drive better operating and SG&A particularly leverage as we go forward.

Operator

Anthony Petrone from Jefferies is online with a question.

Anthony Charles Petrone - *Jefferies LLC, Research Division - Equity Analyst*

Two quick ones for me. Maybe just on masks generally, just an update on the pricing environment overall. And as you get up to speed with some of the new offerings out of the supply issues, do you expect perhaps a little bit of premium pricing on the newer offerings? And then maybe just an update on inventory cycles, receivables, cash. It looks like inventory has ticked up a bit as well. And I'm just trying to reconcile that with the supply constraints.

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes, thanks for the questions, Anthony. I'll hand the first part of the question to Jim Hollingshead to talk about pricing and the second part to Brett.

James Hollingshead - *ResMed Inc. - President of Americas*

Thanks Mick, and Anthony, thanks for the question. What we're seeing is a pretty normal pricing environment relative to historical. And so we're not seeing any unusual decline in pricing. We're seeing the same steady, moderate annual ASP decline that we generally see historically in the industry. All of our mask offerings are priced at a premium. We're the market leader. We're the strongest provider in the industry and we have premium pricing. The new masks themselves also are at a premium to the -- what was the existing portfolio.

Brett A. Sandercock - *ResMed Inc. - CFO*

Yes. And Anthony, just on the inventory, some uptick there. But we're definitely rebuilding through the supply chain to support the new product introductions and to get us into that good strong supply position. So an element of that is building for that. And you see that reflected at June 30 in the inventory balances.

Operator

Suraj Kalia from Northland Securities is online with a question.

Suraj Kalia - *Northland Capital Markets, Research Division - MD and Senior Research Analyst*

So Mick, 2 questions from my side. First on Brightree, can you quantify the OUS or ex-U.S. opportunity for us?

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Thanks for the question, Suraj. Yes, Brightree has been laser-focused on the U.S. HME industry and has an emerging vertical that they're building in home health and hospice. And so we think the value provided is incredible there. The skill sets, so none of the existing modules, if you like, from Brightree would be copied and pasted into our German business or to our French business. But the capabilities of running a Software-as-a-Service business, getting strong annually recurring revenue, monthly recurring revenue from customers, having them pay for software per user per month is a very strong capability. And so we think that out-of-hospital Software-as-a-Service capability is an incredible strength that ResMed now has. And we are looking to, as I said in the prepared remarks, expand in home nursing and expand in home health and expand in hospice within the U.S. environment. We're also looking to expand our Software-as-a-Service offerings in France and Germany and the U.K., Probably not a direct copy and paste. It's more of a longer-term approach to that. Some things that we are looking to copy and paste and, in fact, have already started to do that are in the area of the Air Solutions ecosystem, including AirView and myAir. So the AirView software for physicians and for homecare providers has already been set up with service based in Europe according to European law or the European security protocols and in line with the needs of our European customers. So AirView is going there. In addition, myAir, the patient app, that's universal, right? Humans are the same no matter where they are. And just translating it in French or into German or into Japanese is the pathway in making sure that we have all the right engagements around local laws and security and so on. So that's where the scale is in AirView and myAir and in the capability longer term with regard to Brightree.

Suraj Kalia - *Northland Capital Markets, Research Division - MD and Senior Research Analyst*

Fair enough. Mick, one last question. This might be a naive question, Mick. So let's say I have to order a resupply or reorder a mask, whether a full-face nasal what may be, and let's say the N20 and F20 is not available. What happens to that patient? I guess, I'm just trying to understand, if there were supply issues, did those patients stick with their existing masks? Did they go to the N10 or F10 in the interim? Or if you can just help us reconcile. Because I'm looking at the 4% Americas mask number. Part of me is like, the patients, are they waiting for these new masks to come online? Or did they switch to N10 and F10? Any color would be great.

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Yes, so Suraj, that's a really good question. And one thing that we talked about internally when we saw our supply constraints was focusing to make sure that we had resupply for customers versus going after a new patient sale. And so as I said, there were some perishable sales lost in the first half of the quarter of some new patients that we wouldn't have got onto our ResMed mask. And the customer made the choice whether they went to an N10 or an F10 or to a competitor's mask. And losing 6 weeks or 8 weeks of first-time [synapses] is a bad thing to do. But what's worse is, to your point, not being able to resupply an existing customer. And so we really worked with our homecare customers to make sure that any resupply needs, from -- and a mask can only have been out there 6 to 9 months. And so it wasn't a huge population resupply but that the supply was focused on resupply of patients who'd already loved the N20 and F20, so that we continue to have those patients, really our homecare customers, continue to have those patients supplied with ResMed masks for their life. And so that was a nuance during the quarter. I see we're just past the bottom of the hour, and so we should probably end the Q&A there, Mariama?

THOMSON REUTERS

Operator

Okay, thank you. We are now at the 1-hour mark, so I will turn the call back over to Mick Farrell.

Michael J. Farrell - *ResMed Inc. - CEO & Director*

Great. Thanks. And I guess I could have handed this to myself, but thanks, Mariama. In closing, I want to thank the now more than 6,000 strong ResMed team here at ResMed as they've been diligently driving execution of N20, F20, AirTouch, AirMini launches as well as the future pipeline and even more innovative product and software solutions that we will launch as we move ahead. Our team continues to demonstrate unwavering commitment to changing the lives of tens of millions of patients globally, and we remain laser-focused on our goal of improving 20 million lives by 2020. We will talk to you again in 90 days with our Q1 FY '18 results. Thank you for your time.

Agnes Lee - *ResMed Inc. - Vice President, Investor Relations and Corporate Communications*

Thank you again for joining us today. If there are any additional questions, please feel free to contact me. The webcast replay will be available on our website on investor.resmed.com. Mariama, you may now close the call.

Operator

This concludes today's conference call. You may now disconnect.