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Allen Charles Lutz *BofA Securities, Research Division - Associate*

PRESENTATION

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

Allen Lutz, analyst here at BofA. We're happy to have Henry Schein here. We have the CFO, Ron South. Ron, thank you for joining us.

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

My pleasure.

QUESTIONS AND ANSWERS

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

So Ron, maybe a good place to start is where Henry Schein's systems and core platforms stand today after recovering from the cybersecurity incident. Can you just provide kind of an update in regard to client access, capacity and the resolution overall?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Certainly. I'm pleased to say we are at business as usual. Everything has been completely restored. We're kind of going through a process now, kind of the tail end of a process, a bit of a postmortem, have identified some areas that we want to make a few changes. But it's like I told you, we got a question on this from an investor a while back, and I said, "You could spend all the money you have on cybersecurity and you still don't have 100% certainty of being protected from a cyberattack."

So while we, of course, have done, I think, a very good review of where we are in cybersecurity, which we felt was actually quite strong prior to the cyberattack, we're also looking at what's the appropriate investment to make to assure that, in the event of another cyberattack, we can recover much more quickly. I think that becomes a key part of it is the recovery through backup systems and the timing of that recovery versus only trying to prevent the attack. But I think right now, for our customers, for months now, it has been a nonevent for them. And there's been a lot of internal work, as you can imagine, but I'm happy to say that we're back to normal.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

That's great. And as we think about your first quarter results, I think you talked about 300 to 400 basis points of impact to revenue from that cybersecurity incident. As we think about what's embedded in 2Q, is there any type of lag impact around the cybersecurity announcement or issue and then expectations for the remainder of the year? Is there anything you can kind of glean out from what's embedded in the guide for the remainder of the year?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Certainly. So, first of all, we were very, very pleased with the customer recovery that we had. The cyberattack occurred in mid-October, and we really felt like within several weeks of it, we really had our customer base back probably within about 5 to 10 percentage points of the total. And over time, we've been able to add a big chunk of that back.

The piece of business that was most difficult for us to recover was, what we would call, episodic customers. These are customers who don't have a sales rep. They go online. They buy some things from us. They might buy some things from other distributors. Your website goes down. It's kind of like, I've said this, like if you would go to Amazon and try to buy something in their website, it was down, you would just go to another website. It's just a transactional type of relationship with them, right? And we're very pleased with the volume of recovery we've had. We still need to work on that last piece. That one was kind of 300 to 400 basis points of market.

What we experienced in Q1 was kind of an ongoing effect of that, that we saw come through in Q1. The challenge we're getting to now is as we get further and further away from the cyberattack, and it's been 7 months now, it's becoming increasingly difficult to assess based on changes in the market, what other things that might happen, natural churn of customers, what is cyber effect, what's not. What we saw in Q1, we were able to come up with a reasonable estimate of what we thought was cyber effect, and we referenced that when we said that it was consistent with our expectations as we communicated in our guidance.

Going forward, it's getting increasingly difficult to assess that estimate. We do know that there's been some improvement over the course of Q1, January, February to March. We're continuing to see some improvement, but it's on the margins. We continue to take a look at where we think we can still gain additional market share. To me, the important thing is we ran out several different models. And while we did adjust our revenue guidance a little bit, partially due to what we see as recovery from cyber, we didn't have to adjust our earnings guidance, our EPS guidance. So our affirmation of guidance takes into account the different scenarios that could play out as we go through the recovery. But we're so confident that we can keep it within that $5.00 to $5.16 a share of non-GAAP EPS.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

That's really helpful. And on last week's call, you talked about how dental patient traffic trends began to improve in March, continued to improve in April. Can you talk about what you're seeing in April and May? And then what's embedded as it relates to patient traffic utilization in the guidance for the remainder of the year?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Certainly. So over the course of Q1, we did see, I think, a relatively soft January. And the difficult thing there was how much of that was due to weather, how much of that was due to a high flu infection rate that we think was increasing cancellations for some of our customers. We began to see it improve in February, plus we felt like we were gaining, again, a little bit of market share over the course of February as we come out of the cyber incident. And that continued into March. So we were encouraged by the positive trend, January, February to March, that sequential trend, and we saw April be relatively stable versus March.

I can't really talk to May at this point. I mean we are kind of monitoring how things are going in May. But I would say that we're not seeing anything that would be drastically different than what we have experienced in March and April.

I'm sorry, what was the second half of your question, again, I'm sorry?

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

So just what's embedded in terms of the guide for the remainder of the year.

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

In terms of the patient traffic, yes. So patient traffic mostly affects consumable merchandise sales for us. It's that churn of people going through the practitioner's office, their churn of PPE, cotton balls, all the things that get used and thrown away after a patient's visit. So as we see patient traffic stabilize, we expect consumable merchandise sales to stabilize as well. If we get a little more patient traffic lift, we expect to get a lift in merchandise revenues. But as long as they can stay stable, then we're confident that the merchandise sales is going to stay stable as well.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

As we think about the updated revenue guidance, 8% to 10% growth, can you unpack, I guess, a couple of things. One, I think FX was expected to be, I think, a 50 to 100 basis point tailwind now. I think that was reduced as a tailwind. But can you talk about what's now embedded in that 8% to 10% guidance? What gets you to the high end? What gets you to the low end of that range? What are maybe the couple of major factors there?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Yes. Probably the items that are most fixed, fixed probably isn't the right word, but those that don't influence the range as much would be FX. We're probably at about 0.5 point. We're probably something closer to that lower end of the original range. Acquisition growth, we still see as about 3 percentage points of growth that we can get over the course of this year from acquisitions. There's also a piece in there where we see technology and value-added services growing a little faster than the balance of the business, contributing about 1 point of overall growth for us. That's part of that. Then you throw in the cyber effect we had in Q4 and kind of the mathematical normalization of that is also about 3 percentage points.

This goes back to kind of some of the flatness we've seen. We do think on the specialty side, we can get a little bit of a lift there. What it does for the overall growth could be, say, 0.5 point. And then when you start getting into dental merchandise, dental equipment, and the medical business, I think those are going to maybe give us a little bit of a lift. But those are going to be pretty flat year-over-year. When you add all that up, you still get kind of to that 8% to 10% range. What could push us higher would be if we begin to see a little more patient traffic and a little more churn on that merchandise, and that could push us towards the higher end of the range.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

I want to talk about the value-added services business. And I think you reported 13.6% growth in the first quarter, but there seem to be a couple of items going on there that maybe indicate that revenue could accelerate over the course of the year. It sounded like Change impacted Henry Schein One growth in March, and then you have some new software products that are set to launch later this year. How should we think about the revenue growth rate in the first quarter and some of the drivers that I mentioned and how that can impact growth into the last 3 quarters of the year?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Certainly. So the 13.6% number you cited is an overall growth number that includes the effect of some acquisitions, the most significant of which was a transaction we did last year called Large Practice Sales, LPS. LPS, they really help larger practices who want to divest either in a sale perhaps to a DSO or perhaps if they want to merge with another large practice. And so they contribute to that overall growth, and they will continue to do so until it annualizes. I believe that was about a July 31 transaction we did last year, so that will continue to be acquisition growth for us for the next several months.

The internal growth in that segment was about, if I recall, 3.7%, which is lower than we would normally get. And that's where we kind of talked about the effect of Change Healthcare in March on Henry Schein One, which is somewhat of an indirect effect. I mean we do have an e-claims service we provide our customers, and that was interrupted somewhat. There was also just overall disruption to not so much to systems but to how our practitioners could run their practices. It resulted in a high volume of calls to our health centers, which was somewhat disruptive to our ability to maybe sell additional practices or sell additional products, technology products, to these practices. So we did see a dip in March associated that coincided with the timing of when we began seeing more and more disruption to our customers' practices coming from the Change cyberattack. So we think that's kind of played out now. There's still maybe a little bit of backlog as it related to the processing of claims.

I think we did a very good job of helping our customers get their claims processed through another exchange, through a company called DentalXChange. But there was still some delay in getting payments made of those claims because the payments were still processed by Change. So while we could help them get the claims processed, there was still a delay in actually getting cash. And a lot of them were hoarding cash at that point. They were trying to manage a lower cash balance. And so you didn't see a lot of them deciding that they were going to run out and maybe buy another, like a business analytic tool or something, that they were going to tag on to their existing technological platform.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

As we think about the Henry Schein One suite of products, can you talk about the penetration rate within your core customer base? And then what's the typical sales cycle like for this type of suite? And when they buy a product, where are they typically buying? What are typically the upsells? I'm just curious what a typical path of a customer would look like.

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

So the core product there is a practice management system called Dentrix. Dentrix is the on-prem product that helps really assist the fundamental back-office management of the practice that will allow the practitioner to make the appointments, send out the reminders. That's really the nuts and bolts of the system.

There's also Dentrix Ascend, which is an SaaS model. So that's a subscription-based model as opposed to the on-prem model. Like I mentioned before, there's an e-claims service that they can use based on the volume of insurance claims that built based on that volume to the practice. There's also a business analytic tool that we called Jarvis Analytics that allows the practice to get kind of a financial dashboard of various different metrics within the practice so they can identify where they can increase their profits, how they can actually increase the rotation of patients who are coming in through the practice.

And then there's also a patient experience module that is really more of a how to pull more patients into your practice, increase that patient traffic through better use of your website and how it interacts with Google and various different online searches, and that will increase patient traffic. So those are all various different modules that can be attached. But the core is really that practice management system. And then there's always the opportunity then to increase the revenue base from those existing customers as they begin to get more familiar with those other modules.

Really, one of the newest things we've introduced through Henry Schein One is a product called Detect AI. Detect AI is an artificial intelligence tool that's really a supplement to the diagnosis process that a dentist would follow when taking an X-ray of a patient. So they can take the X-ray, send the X-ray through our Dentrix process, to the patient's records. And then it will interact with millions of X-rays, come up and show through little markings where there are vulnerabilities that are popping up in that X-ray. It allows the dentist to really sit down with the patient and have a very meaningful discussion of here's an area where you may be getting problems in the future. You might not have pain now, and you can develop a treatment plan right there that will be much more, hopefully pleasant, patient experience for the individual because they're not going through waiting until they have that painful cavity to get it filled.

So that's actually a subscription base as well that we're selling through Henry Schein One. We've got one of our larger DSO customers that has purchased it for all of their practices. And so it will be an interesting development to see how this will impact their practices because what we've seen early on is that those who are using Detect AI have meaningful increases in the number of restorative procedures they're doing as well as periodontal procedures they're doing. So there is an ROI associated with the subscription base that they're doing because, if it's increasing these procedures, it's clearly covering the cost of their subscription.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

So my dentist actually subscribes to that. So I've got to see it in action, which was really cool to see.

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Hopefully, everything was okay.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

Well, I floss too much, so I have some recession. Every time I go to the dentist, they bring it up, so it's a sore spot. But switching gears a little bit here on the value implant side. You've acquired some businesses there. You have some new launches in the second half of the year. Can you talk about the commercial strategy for implants and how that could impact the P&L in the second half of the year?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Certainly. So you mentioned the value implants first, so we'll start with that. One of our transactions last year was a company called S.I.N. out of Brazil. They have a couple of different implant products, including a value implant that already had FDA approval in the U.S. And BioHorizons, our U.S. subsidiary, that manufactures and sells implants, did not have that as part of its product portfolio. They do not have that type of value implant. So we've now been able to start selling the S.I.N. value implant through our BioHorizons subsidiary in the U.S., and it gives it a broader product portfolio.

In addition, we are pending FDA approval, and hopefully going to be getting it very soon, of what's kind of called a conical deep connection implant. Deep connection means it actually connects to the bone as opposed to the tissue. And it's very similar to the implant that we sell in Europe through Camlog. So it's based on the same technology, not the same implant, but it's based on the same technology. That's I think one reason why we're very close to getting the FDA approval because it is a proven product in Europe. That's going to open up a larger part of that addressable market that we're not selling through right now in the U.S. And we think that's going to be an opportunity for us to accelerate revenue growth a little bit in the second half of the year in our dental specialties area.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

I want to talk about gross margins because they've been expanding nicely, and there seem to be a couple of reasons why they are doing so. Obviously, the value-added services business and then some of the businesses that you're acquiring and manufacturing and your own brands really is supporting that margin expansion. Is there any way to frame your expectations for gross margin expansion? What inning are we in? How do you think about the drivers of gross margin expansion? Are there any levels that you're thinking about as it relates to where margins could get over time?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Yes. Gross margins were very good in the first quarter, and a lot of that is attributable to mix, but it's really kind of following our strategic plan. Our strategic plan was to increase the contribution to our P&L from specialty businesses that are growing faster, that have a higher margin, as well as our technology business and other value-added services businesses. So a lot of the transactions we did last year, and we did $1 billion in acquisitions last year, were in those areas. And we're beginning to see the benefit of that as we get into 2024.

So I think the gross margin we achieved in Q1 should be representative of what I believe we can do the balance of the year. Some of the things that could impact that would be if we have, say, a little better growth in distribution than what I'm anticipating right now. So distribution tends to be slightly lower margin. But I would take that trade-off, I would take the trade-off for a little better growth in distribution, if that's what we can get. So mix could impact it a little bit going forward, but I don't expect it to change significantly for the balance of the year. As we can continue to get good growth out of our specialty businesses and out of Henry Schein One, our technology business, there is opportunities for that gross margin to expand as we go into '25 and beyond that.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

Switching to medical. There was an announcement this morning that the Biden Administration was announcing tariffs on Chinese imports. Can you provide us where does Henry Schein manufacture its gloves? And do you see any type of impact from these proposed tariffs?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

So we don't manufacture really any of our own gloves. We do rely on suppliers in China as well as in Malaysia for gloves. About 1/3 of it comes from China, about 2/3 from Malaysia. The effect of the tariffs will typically increase costs, but not to a point where we are not able to pass along the effect of those increases. So I guess I would compare it to the environment we saw in 2022 when, at least relatively speaking, in the U.S., we were experiencing higher inflation than normal. We did see some manufacturers increasing prices, increasing cost to us more so than they normally would and more frequently than they normally would, and we were able to pass those increased costs along.

In those situations where we weren't able to, we were able to kind of move customers to our private label products. And I would say that if, in fact, the tariffs become an issue in terms of our ability to pass along costs, we'll have to see if we can increase our reliance on product from outside of China from other areas. Like I said, we get 2/3 of our gloves now from Malaysia. Having said that, there's other products besides gloves that we're getting from China. But to the extent we're not able to pass along those costs, we can look for alternative means. But I'm not expecting it to be a problem. I don't see this as a big negative for us.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

Very helpful. Switching gears again on capital budgets. On the dental side, you mentioned a few larger DSOs have paused spend, but others in the market are buying and installing equipment and they seem to be growing. Can you expand a little bit on that? Where are you seeing strength in your DSO customers? Where are you seeing weakness? And can you kind of tease out private practice budgets? Sort of where are they today versus maybe 6 to 12 months ago?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Certainly. So the standard equipment market in general has leveled off a little bit. It was a pretty hot market. Coming out of the pandemic, you had a lot of disruption to the end market for dental. There was a higher rate of retirements amongst dentists. You also had a lot of patients that were changing dentists. I mean, a lot of people change from going to a dentist close to where they work to dentists close to where they lived, if they began working from home more frequently. So there was a lot of disruption kind of in that end market. That created a lot of opportunity for some practices to expand their practices or to renovate their practices. And we saw really a very strong demand for standard equipment, whether it be in private practice or in the DSOs, so it was really in either.

That has, I think, started to settle. I mean at some point, and we even said then when we were experiencing double-digit growth in standard equipment year-over-year, that, that was not sustainable. We didn't expect that to be sustainable. But what we're seeing now is an increase in that base business of standard equipment. So the growth is a little skinnier. But nevertheless, we're still seeing fairly healthy demand.

Some of the DSOs, like you said, have clear access to capital, are still expanding, and we're able to sell them equipment. There are some DSOs out there that have pulled back a little bit. Their access to capital has been squeezed a little and they have pulled back a little, but not to the point that it's that concerning to us. But there is a little bit of a trade-off there because we are coming out of a period post pandemic, that there was some pent-up demand for standard equipment.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

On capital deployment, Henry Schein has been very acquisitive over the past couple of years. Can you talk about the capital deployment strategy as you think about M&A versus share repo and some of the other things you're prioritizing on that side?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Certainly. So in a typical year, we can generate $600 million to $700 million of operating cash flow, and we actually expect this year to be a little higher than that, which really is primarily due to we went into the year with a much higher receivable balance coming out of the cyberattack because of the timing of when we were able to get some billings out. We saw those receivable balance normalized somewhat in Q1. Ironically, the Change Healthcare issue probably kept our receivable balance a little higher than we expected at the end of Q1, but we had very good cash flow in Q1 that we expect to continue into the balance of the year.

Prior to 2023, in a typical year for us, we were doing $300 million to $400 million of M&A and, say, $300 million to $400 million in share repurchases. Then in 2023, we did $1 billion in M&A. I can tell you with a fair amount of certainty, we would not be doing $1 billion in M&A in 2024. I think we don't have the management capacity to successfully continue integrating businesses at this rate. We want to make sure we do a good job with the ones we did last year. But we still have acquisitions in the pipeline. We did do the transaction with TriMed that closed right at the 1st of April. That's our kind of introduction into extremity orthopedics within our medical business. So that type of transaction, which fits in well with our strategic plan, we're still interested in doing. But I don't expect it to be $1 billion.

In addition, this year a little differently than in prior years, we are carrying more debt than we have historically. And so as we go through the kind of accretion process of where do we get the best benefit and how do we optimize capital outlay, we're looking at both share repurchases as well as pay down of debt. We're happy with the interest rates we got on that debt. So we're not in a huge hurry to pay it down. Especially with where we are with interest rates now and what's happening with our share price right now, we think there's still some good share repurchase opportunities out there. But we will look at that trade-off and see where we think we can optimize that capital outlay.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

And I guess with about a minute left, Henry Schein, I would think, has a unique opportunity to see things given that it has revenue cycle software. We've heard and we looked at data that would suggest that Medicare Advantage is a growing part of dental spend. Is that something that you can see looking at your revenue cycle? Do you have access to the claims data by payer where you'd be able to see whether or not Medicare Advantage is a growing contributor to dental spend? Or is that something that's a little bit out of scope for Henry Schein?

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Well, we don't have significant visibility into that. So it would be hard for me to comment on it. But stepping back from a bit and just looking at it from a higher level, access to care is always a big positive for us. Access to care means more traffic going through the dental office, more traffic going through the physician's office. And so to the extent it either extends or increases the access to care through the Medicare program, then we see that as a general positive for us.

Allen Charles Lutz - *BofA Securities, Research Division - Associate*

Great. Well, it looks like we're out of time. Thank you so much, everyone, in the audience for joining us. And thank you, Ron, for the time.

Ronald N. South - *Henry Schein, Inc. - Senior Vice President and Chief Financial Officer*

Thank you.