MEMORANDUM

Alere 2Q14 - Diabetes revenue down 32% YOY; CEO Ron Zwanziger resigns - August 14, 2014

Executive Highlights

- Diabetes sales of $51 million declined 32% year-over-year (YOY), marking the first decline since Alere re-entered the diabetes business in 2011.
- Mail-order diabetes revenue totaled $33 million, down 41% YOY, despite a 71% increase YOY in patients served (778,000 patients served in 2Q14, up from 455,000 in 2Q13).
- The company did not comment directly on the July 1 resignation of CEO Ron Zwanziger.

Alere interim CEO Namal Nawana recently led the company's 2Q14 financial earnings update. Below, we bring you our top four highlights.

1. Diabetes sales (mail-order supplies, in-patient point-of-care, and laboratory testing) totaled $51 million, down 32% as reported year-over-year (YOY) and flat sequentially. This marks the first YOY decline we have observed since Alere re-entered the diabetes business in 2011.

2. Mail-order diabetes revenues totaled $33 million, down 41% YOY despite a 71% increase in patients served (778,000 in 2Q14, up from 455,000 in 2Q13). The company attributed these effects to the decrease in reimbursements rates from competitive bidding (effective July 1, 2013), echoing commentary mirrored from the Big Four BGM companies' 2Q14 updates. We would not see competitive bidding having a sequential impact - this was not addressed.

3. Alere's Board of Directors accepted the July 1 resignation of CEO Ron Zwanziger and appointed Mr. Namal Nawana as Interim President and CEO. The company is re-evaluating its entire portfolio, though the implications for diabetes are not clear. Comments centered on the "excessive breadth and profound inefficiencies" created by acquisitions. We would be surprised to see any significant investment into diabetes going forward.

4. There was no mention of expectations for 2H14. However, during Q&A, management did comment that, "this is the last quarter where we see the year-on-year challenge with respect to our mail-order diabetes business," implying an annualization of competitive bidding.

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TOP FOUR HIGHLIGHTS

1. Diabetes sales (mail-order supplies, in-patient point-of-care, and laboratory testing) totaled $51 million, down 32% as reported year-over-year (YOY) and flat sequentially. This marks the first YOY decline we have observed since Alere re-entered the diabetes business in 2011. This comparison was particularly challenging, as diabetes revenue grew 103% in 2Q13 (the acquisition of Liberty Medical in late April 2013 netted Alere $30 million in revenue, or ~40% of the company's $75 million in sales in 2Q13). Revenue from the acquisition has not been broken out for the past year, making it impossible to know the business' exact organic growth. Still, it appears that Alere's diabetes business has been hit just as hard as the

Big Four blood glucose monitoring companies (Abbott, Bayer, J&J, and Roche). For context, Abbott global revenue declined 10% as reported and operationally YOY in 2Q14; Bayer revenue declined an estimated 10-16%; Roche Diabetes Care revenue fell 10% as reported and 4% operationally YOY; and J&J revenue fell 5% as reported and operationally YOY.

- **Management highlighted that strong Professional Diagnostics sales in Africa and India were partially offset by a 2Q13 diabetes tender in Brazil that did not recur.** International diabetes revenues were not described in any additional granularity.

Table 1. Alere Diabetes Sales for 1Q13-1Q14

	1Q13	2Q13*	3Q13	4Q13**	2013	1Q14	2Q14
Total Revenue (millions)*	$50	$75	$53	47%	**$225**	$51	$51
Year-Over-Year Growth	78%	103%	47%	8%	**56%**	1%	-32%
Sequential Growth	14%	50%	-29%	-11%	-	7%	0%

*Alere acquired the Liberty Medical business in late April 2013. **Alere acquired Simplex Healthcare in November 2013.

2. Mail-order diabetes revenues totaled $33 million, down 41% YOY despite a 71% increase YOY in patients served (778,000 patients served in 2Q14, up from 455,000 in 2Q13). Mail order sales were flat sequentially from 1Q14. For the second consecutive quarter, the company's press release attributed these effects to the decrease in reimbursements rates due to competitive bidding, which became effective more than one year ago on July 1, 2013. At this point, we had expected to see the declines from competitive bidding start to taper, since the program has annualized - 2Q14 calls from the Big Four (Abbott, Bayer, J&J, Roche) suggested that is not he case. In prepared remarks, management attributed the 4% decline in global Professional Diagnostics revenue "principally" to lower US sales from the diabetes mail-order business. The company's drop in adjusted gross margin from 50% of net revenue in 2Q13 to 46% in 2Q14 was also partially attributed to the lower mail-order diabetes reimbursement rates (along with recalls in other areas of Alere's portfolio).

- **For background, diabetes revenue made up only 9% of Professional Diagnostics sales in 2Q14, while the mail-order business comprised 65% of Alere's diabetes business**. The 9% of total Professional Diagnostics sales attributable to diabetes decreased from 12% in 2Q13. The proportion of Diabetes sales from the mail-order business has remained roughly the same.

Table 2. Mail-order Supplies Sales

	2Q13	3Q13	4Q13	1Q14	2Q14
% Mail Order of Total Diabetes Revenue	75%	63%	63%	63%	65%
Mail-Order Revenue (millions)	$56	$34	$30	$32	$33

3. Alere's Board of Directors accepted the July 1 resignation of CEO Ron Zwanziger and appointed Mr. Namal Nawana as Interim President and CEO. This decision followed from a "comprehensive strategic review of the company's operations" by a "major international consulting firm." There were no further comments on the resignation. As a reminder, Mr. Zwanziger joined Alere as CEO in 2001. Before his time at Alere, Mr. Zwanziger was a force in diabetes, having served as CEO of both MediSense (1981-1991) before its sale to Abbott for ~$900 million in 1996 (Mr. Zwanziger left Medisense after Dr. Bob Coleman was hired to take on the CEO position), and Inverness Medical Technology (1992-2001) before its sale to J&J for $1.3 million in 2001. Both were sold at high revenue multiples at a time when blood glucose monitoring was a very profitable business. Mr. Zwanziger began developing Alere's diabetes care business in 2011 with the acquisition of point-of-care A1c provider Axis-Shield and diabetes testing supplies provider Arriva Medical. Although Mr. Zwanziger had been optimistic about Alere's diabetes care prospects, the field has changed markedly within the last several years, and we wonder if his departure is a sign of less focus on diabetes moving forward.

- **Discussions of Alere's reorganization and new strategy were focused at the global company level, rather than diabetes specifically.** Still, it seems clear that the previous strategy used by management - including Mr. Zwanziger - is being completely revamped; this makes us wonder about the implications for the diabetes business. Management frankly stated that the prior operating strategy resulted in "excessive breadth and profound inefficiencies." Further, "prior management had failed to coherently integrate many of its more than 100 acquisitions" - several of which, we know, are related to the company's diabetes business and mail-order supplies. This makes us contemplate how the company will move forward with these multiple diabetes entities - if anything, we would be very surprised to see an expansion in the diabetes business, particularly given the challenging nature of that business.
- **Management explained that Alere is in the process of re-examining each business unit "to understand its strategic place within the company."** Additionally, within each business unit, the company is evaluating each product from the "bottom up" to determine the best allocation of resources. Again, it is not clear what this means for the diabetes business. Management did comment on the impressive - albeit underperforming - market-leading technologies of the Professional Diagnostics business as a whole. Commenting on overall business strategy, we also heard that the acquisition of a broad array of assets over the past decade has "ultimately hindered" financial performance. The diabetes business was certainly acquired via acquisition over the past decade, and we again wonder if that was one of the businesses management was referring to.
- **Mr. Nawana commented that the company is moving toward a business model centered around Alere's core strengths in rapid diagnostics - particularly infectious and cardiometabolic disease, and toxicology.** The mention of cardiometabolic disease does provide some expectation that diabetes will be a focus, though we'd note that Alere also sells cholesterol and cardiovascular-related diagnostics, meaning diabetes may not be a focus area moving forward. However, Mr. Nawana did not mention the diabetes business when he spoke to different areas of the business that have been divested or that the company is looking to stop investing in (e.g., oncology, women's health, and veterinary products). He noted that more formal plans will likely be announced within the next few months.
- **Mr. Nawana has "observed numerous opportunities to improve the business" over the past year and a half,** although he had not been in a position to act upon it until now (the situation has "been corrected"). The fact that Mr. Nawana had already been previously working on strategy before the departure of Mr. Zwanziger makes us particularly curious as to what his role will be in the future of the company - certainly, he appears to be a key leader in impacting company strategy.

4. Management did not mention any financial or pipeline expectations for 2H14, although did comment during Q&A that "this is the last quarter [it] expects to see YOY challenge with respect to the mail-order diabetes business" - this makes sense as there will have been an annualization of competitive bidding. Alere's mail-order diabetes business was down 40% sequentially in 3Q13 compared to 2Q13. Given how other companies have fared recently and expect to fare in 2H14 (J&J,

Abbott, Roche, and Bayer), we would not be surprised if the challenges persisted for additional quarters due to other pricing pressures in the field. Bayer's 2Q14 call specifically noted that it "[plans] to see a decline in Diabetes Care" in 2H14 driven by the US. On the other hand, J&J seemed to share Alere's optimism, stating that it was seeing "improved performance" and would be "lapping" competitive bidding, now that the program had annualized.

QUESTIONS AND ANSWERS

Q: Can you describe how much of the performance in 2Q14 can be credited to distractions due to management changes?

A: Financial performance in the quarter was more related to challenges in the US, which principally related to the product recalls and challenges in pricing with respect to the toxicology business, in rehab. And, equally - we've talked about it before - this is the last quarter where we see the year-on-year challenge with respect to our mail-order diabetes business, where we had substantial decrease in revenue versus prior year. So I would say that the results in financial performance of Q2 are related to those effects.

-- by Varun Iyengar, Hannah Martin, Adam Brown, and Kelly Close