24-Feb-2022

Elekta AB (EKTAY.SE)

Q3 2022 Earnings Call
CORPORATE PARTICIPANTS

Cecilia Ketels  
Head-Investor Relations, Elekta AB

Gustaf Salford  
President & Chief Executive Officer, Elekta AB

Tobias Hägglöv  
Chief Financial Officer, Elekta AB

OTHER PARTICIPANTS

Victor Forssell  
Analyst, Nordea Bank ABP

Veronika Dubajova  
Analyst, Goldman Sachs International

Kristofer Liljeberg-Svensson  
Analyst, Carnegie Investment Bank AB

Karl Norén  
Analyst, Danske Bank A/S (Sweden)

Rickard Anderkrans  
Analyst, Svenska Handelsbanken AB

David Adlington  
Analyst, JPMorgan Securities Plc

MANAGEMENT DISCUSSION SECTION

Cecilia Ketels  
Head-Investor Relations, Elekta AB

Good morning, everyone, and warm welcome to the presentation of Elekta's Third Quarter 2021-2022. My name is Cecilia Ketels, and I'm Head of Investor Relations at Elekta. With me here in Stockholm, I have Gustaf Salford, Elekta's President and CEO, and our new CFO, Tobias Hägglöv, who will be presenting the results. Tobias started his role in February, so 24 days into his job, he's now presenting the quarter.

Today's agenda, start off by Gustaf presenting some highlights of our development, and then Tobias will give you details on the financials, and the presentation ends with Gustaf's view on Elekta's outlook. And after the presentation, there will, as usual, be time for your questions.

But before we start, I want to remind you that some of the information discussed in this call contain forward-looking statements and this can include projections regarding revenue, operating result, cash flow, as well as products and products development. And these statements involve risk and uncertainty that may cause actual results to differ materially from those set forth in the statements.

And with that, I hand over to you, Gustaf.

Gustaf Salford  
President & Chief Executive Officer, Elekta AB

Thank you, Cecilia, and good morning from me as well to everyone on the call. So, as usual, I would like to start with highlighting our strategy, ACCESS 2025 and what activities we have been driving in the quarter to execute on our strategy. And in the area of accelerate innovation, we have really driven our projects forward, progressing
well in the focus areas of the Linac family, the Unity platform and our software solutions. We also received great feedback on the new Unity functionalities we launched in the autumn, and we are progressing very well with a clinical evidence and reimbursement journey for Unity.

We continue to roll out our new Linac, Harmony, to customers and markets around the world, and we see a strong price and profitability levels being realized. To drive partner integration across the cancer ecosystem is truly a focus area for Elekta, and we continue to develop our partnership with Philips in the quarter, and we see and realize strong opportunities, both on the commercial and the innovation side from the partnership. Our patient reported outcome company, Kaiku announced that they’re doing studies together with MSD in the lung cancer and cancer immunotherapy area. When it comes to being the customer lifetime companion, Elekta is – expanding our service offering and moving towards new business models, we are expanding value-added services. And the target in this area is really to drive service revenue growth higher than the installed base growth.

Now, moving to drive adoption across the globe strategic pillar. And we’ve seen that due to higher vaccination rates globally, I’m really pleased to see that the access to customers are getting easier in many parts of the world, and one of the examples in the quarter was the Arab Health Conference with large physical attendance and it was truly fantastic to be able to meet customers and partners from around the region face-to-face again. We also drove geographic expansion and you’ve seen that in previous quarters as well.

And during the quarter, we started our direct presence in the Philippines, in Manila, and we also took the opportunity to launch our Elekta Foundation during the Expo 2020 in Dubai and the focus of the foundation is really to expand the training and education in cancer care, strengthening cancer care infrastructure, but also increase awareness and prevention of cancer. We are accelerating our resilience and process excellence initiatives across the value chain and organization. These initiatives has been absolutely vital to be able to continue to deliver solution and services throughout the pandemic, and with all the supply chain disturbance we have seen over the last couple of quarters. But going forward, we will accelerate these activities to support our margin expansion, and I come back to this important topic later in the presentation.

Now, taking a look at the recovery phasing for Elekta post-pandemic, it’s good to see that the positive order dynamics seen in the last four quarters continued also in Q3, supported by the pandemic challenges in the emerging markets, East, and these markets also drove the performance together with a truly strong order development in Europe. Our solutions – or devices orders kept growing with double digits and the Linac business had a very strong performance in the quarter, and our order backlog is now at all-time high level, up close to SEK 38 billion.

As you can see on the dark blue line, our revenue was impacted by lower installation volumes compared to the plan in the quarter. I will come back to that.

If we now take a look at the geographic distribution of the orders, you can see that in the Americas to the left, order intake decreased by 3%. The region faced some challenging comps, especially in the US from last year, and also the Omicron wave in the US brought down the orders a bit in Q3. However, South America returned to growth with the larger markets, such as Mexico, Colombia that was delivering true strong growth.

EMEA, in the middle, you can see here, had a very strong order growth of 23%. Europe continued to drive double-digit growth with great performance across the region, and we also saw that the Middle East and Africa returned to growth in this quarter and delivering strong figures and numbers. And the highlight was truly Egypt, where we went in with an own presence not that long ago, and you can see it really pays off. We also saw good development in Ghana and Turkey.
If we then move to APAC, it decreased by 3% and was mainly due to the Chinese market being a bit slower during the last months. But we saw strong growth in India, Japan, and New Zealand, and as well as in Australia. And we also saw that the East Asian markets recovered nicely in the quarter. And on the bottom of this slide, you can see a couple of examples of key deals for Elekta in the quarter.

If you take the overall order growth perspective, we came in at the healthy 8% and we are now at 5% year-to-date. Revenue came in at the lower minus 3% and the decline was really driven by lower solution revenues to the longer supply chain lead times. And it was mainly in lower volume solutions, like the Leksell Gamma Knife in the quarter that relies on global installation teams. However, the service revenue increased by 7%, and here, you see the growth faster than the installed base that was around 4%.

The turbulence in the freight markets and the ongoing challenges around global supply chains made installations in the third quarter more challenging and our margins were impacted. Gross margins came in 36.7% and EBIT margin at 10.4%. And I think it’s crucial to double click or look at the gross margin development compared to last year. And if you see, last year, we were at 38.7%, [ph] so we had (08:26) 200 basis points decline to the 36.7%, you can see to the graph on the left. And if we break down those drivers, the 300 basis points were discussed in the previous call last week, you can see that 250 basis points were impacted by this high logistic costs and longer supply chain lead times compared to last year.

But we also had a smaller effect, about 50 basis points due to higher component prices due to the shortages we see in the market and we need to go to the spot market to a larger extent. But we had a positive effect as well over the solution/service mix that I mentioned before, supporting the gross margin with around 100 basis points in the quarter. Overall, our margins were also affected by the lower installation volumes, compared to the plan we had for the quarter. And I'm, of course, not satisfied with our current margins and we are accelerating our resilience and excellence activities to expand our margins again.

And turning to the activities, that's the resilience and excellence activities I've been referring to. And for the last year, in 2020-2021 that you see here to the left, they were absolutely crucial to prepare us for what we define as the new normal. It was about increasing our capabilities in remote servicing, virtualizing sales, making it digital, and we are now bringing these capabilities going forward in Elekta's processes. But we are also, as you can see to the right, accelerating our resilience and excellence activities to improve profitability and drive the margin expansion.

It would be absolutely key to drive a faster order backlog conversion to revenue over the coming quarters, but we also continue to do new product launches and price excellence initiatives. We are driving digitalization and automation across our processes, and we are driving more shared service deployment to our shared service center that we have in Warsaw. We're driving supply chain optimization between our sites in the UK, Crawley and in China, Beijing to strengthen resilience, and it's also about our environmental sustainability but, of course, also cost. We're localizing key processes, like the installation teams to secure that we can continue to drive the installations or products, like Unity and Leksell Gamma Knife that are now independent on global teams, but we need to, to a large extent, be able to do those installations locally.

And I also would like to give a bit of an update on the establishing of the clinical evidence and the reimbursement journey for Unity. And as you can see on this graph and we see it in different steps, the clinical utilization is progressing very well and we have now more than now 50 sites in clinical use. The current step that our customers are focusing a lot on, and we as well, is the clinical evidence generation and we have seen great progress over the last years. Through our Unity consortium and collaboration between 58 medical centers using
Unity and the MOMENTUM Study, Elekta is committed to support generating the strong evidence. And as you can see on this slide, we're seeing an increasing evidence based on a quarterly and yearly basis.

And today, we are more close to 600 abstracts from the Elekta consortium sites and more than 400 peer-reviewed publications. And when it comes to publications reporting on clinical patient treatment, the progress has been very positive with 26 peer-reviewed articles published today. The next step is really and it's ongoing is to have randomized controlled trials showing clinical superiority, and there's a large number of this ongoing clinical trials at present in the Elekta community. And this will eventually also amount to peer-reviewed publications.

On the reimbursement side, we actively support the local reimbursement processes around the globe and our Elekta teams are currently doing this in many countries; for example, US, Japan, France, Germany, Australia just to name a few. And it is through in-country KOLs, radiation oncology professional societies and, of course, public policy engagement. So, I see this as a very promising development. I will also give you updates on going forward.

So after this update, I'm very pleased to hand over to our new CFO, Tobias Hägglöv that recently joined Elekta, and I'm really, really looking forward and enjoying working with Tobias to continue to drive improvements and value for Elekta going forward.

Tobias Hägglöv
Chief Financial Officer, Elekta AB

Thank you, Gustaf. It feels great to join Elekta, and I can just say, likewise, looking forward to work with you. And I'm also looking forward to work with many of you that are joining this call today.

So, by that, I wish good morning, everyone. And I will now start to talk about the financials, so let's turn slide. Our revenue declined by 3% in the quarter, impacted by the pandemic as Gustaf mentioned earlier. While solutions declined by 8%, our service operations grew by 7%. Our EBIT margin came in at 10.4% in the quarter, adjusted for contribution to Elekta Foundation of SEK 35 million. Looking at the year-to-date development, sales grew by 4% with growth in both solutions of 3%, as well as in service by 5%. Notable to see the healthy development of our linacs and our MR-Linacs. EBIT margin for the first nine months came in at 10.8% based on the same definition as for the quarter.

Gross margin came in with 36.7%. As Gustaf described, higher cost for supply chain, logistics and service costs had an adverse impact on gross margin of approximately 300 basis points compared to last year's third quarter. An improved mix with highest service sales had a positive effect on 100-basis-point on gross margin. EBIT margin decreased mainly due to the lower gross margin just mentioned, but also due to selected investments which impacted our SG&A costs. The net FX impact on EBIT in the third quarter was positive approximately SEK 60 million. Net financial items improved, as we now have lower gross debt levels than last year, and our financial position remains very strong with a net debt to EBITDA of 0.6. The income tax rate in the quarter was 24%.

So now, let's turn slide and look into our expenses. Selling expenses increased by 19%, driven by increased customer-facing activities, resulting in higher travel and marketing costs. Admin expenses increased by 14%. This
increase was related to a combination of low comparables due to the pandemic, as well as investments in
digitalization. Finally, net R&D expenses were 16% lower than last year.

So, let's turn slide and talk more about the R&D investments. In line with our strategy, gross R&D increased in the
quarter. On a rolling 12-month basis, it corresponds to 13% of net sales. The R&D projects are progressing well
and we are investing according to our plan following the capitalization and amortization schedules.

So, by that, let's turn slide and talk about our net working capital. Our working capital development for the first
nine months followed the normal seasonal pattern for Elekta. Net working capital decreased in the quarter and it's
now minus 3% of net sales, which is on the same level as in Q3 last year. Due to the difficult conditions in the
freight markets, we are holding higher component inventory and we are shipping early to mitigate the longer
shipping times to make sure our products reach customers in time for installation. This means, we continue to
carry more inventories than normal.

Now, let's look into our cash flows. Cash flow from operating activities for the first nine months amounted to SEK
818 million, resulting in a rolling 12-month cash conversion of 71%, which is in line with what we have planned for
our operations. Cash flow after continuous investment was SEK 173 million negative with focused investments in
the Linac family and informatics.

So, by that, over to you, Gustaf.

Gustaf Salford
President & Chief Executive Officer, Elekta AB

Thank you, Tobias. And now, I would like to turn to the outlook for Q4 and the mid-term. So, if we start with the
Q4 perspective, we see high demand for installation volume than last year's Q4 in this year's Q4, but component
shortages continue to be challenging. We also see continued high logistics and supply chain costs impacting our
margins. But as I usually state and what we truly see is that the long-term market trends is supporting growth and
investments in high-end radiation therapy equipment and margin expansion.

If we take the mid-term outlook, we continue to have the view of a growth more than 7% of a net sales CAGR and
margin on EBIT percentage expansion also over the period and the capital allocation to having more than 50% of
the annual net profit in dividend.

So, if we then summarize our third quarter, we saw supply chain challenges and it continued to impact our
revenue and margins in Q3, but we also saw a very strong order growth, mainly driven by Europe and recovery in
the emerging markets. And we are at the higher – or highest order backlog ever. We drove additional local
presence in the Philippines when we're driving, as I mentioned before, the ACCESS 2025 strategy, and we see a
very strong platform for profitable growth going forward.

And with that, I would like to hand it over to Cecilia again.

Cecilia Ketels
Head-Investor Relations, Elekta AB

Thank you, Gustaf. Then, we open the lines for your questions. Please, operator, over to you.
QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Okay. And we have a few questions coming through, and the first question comes from the line of Victor Forssell of Nordea. Please go ahead. Your line is open.

Victor Forssell  
Analyst, Nordea Bank ABP  
Q  
Yeah. Thank you for taking the questions. I’ll start off with one. Just trying to understand the quarterly development here of the gross margin and especially since you, in the report, at least, highlight freight as the main driver for the still high logistic costs. I mean, this cannot have come as a surprise for you in January, I guess so. Just trying to understand at what point in this quarter that you were surprised about this sequential decline since one could have expected it would be more flat sequentially?

Gustaf Salford  
President & Chief Executive Officer, Elekta AB  
A  
Yes. Hi, Victor. No, I fully understand that question. And what we saw during the quarter was some and a bit challenging on the installation side. You see also a very dynamic situation on the shipments and installation dates, where we also see it in installed base that we need to shift an installed base, that’s quite the big part of our logistics costs when it comes to, for example, spare parts around the world. So, we knew that we would be impacted, and we said that also of the Q2, but the extent it came in higher than we expected throughout the quarter. And that was both from that logistics cost side, but it’s also due to longer supply chain. So, it was not the specific date, but later in the quarter, I would say.

Victor Forssell  
Analyst, Nordea Bank ABP  
Q  
And could you perhaps be a bit more specific about the sequential sort of bridge here, because I mean – yeah, just to illustrate an example there, please would be helpful?

Gustaf Salford  
President & Chief Executive Officer, Elekta AB  
A  
Illustrate – I think it’s just the dynamic development that our supply chain teams around the world are working day and night to ship and install and service our machines. So, I don’t have a specific date in the quarter when...

Victor Forssell  
Analyst, Nordea Bank ABP  
Q  
All right.

Gustaf Salford  
President & Chief Executive Officer, Elekta AB  
A  
...we saw the higher impacts. And we also saw some of the component prices, but that was a smaller effect this year, I think you saw on the slide of the 50 basis points. So, primarily, these freight costs and logistics costs on the spot market, that is very difficult to forecast at the moment.
And what will need to happen for you to start seeing meaningful gross margin improvements? You provide your activities here, but I guess, they are also for the longer term. So, currently, it looks as if gross margins could be pegged around 39% as long as rates – or even though rates stay flat year-over-year at some point. So, how difficult will it be for you to improve margins as long as the rates are here well above pre-pandemic levels?

I think there are a couple of key components to that question that we also discussed throughout the presentation, but the order backlog conversion to revenue is key, so we get back to growth. We were at minus 3% in the quarter and that's not where we should be based on the strong order backlog we have. So, that's the priority for the company now in Q4 and Q1. We also see, maybe the freight costs will be high, but we see a bit more of the stability in the supply chain system, where the lead times are longer, but the component shortages are reduced to some extent. So then, you are not as vulnerable for short-term shipments and airfreights and so on. That's very costly. So, we see that higher stability coming going forward as well.

Then, its product mix. And as we mentioned, the Q3 came in a bit lower on the Neuro side that's dependent on global installation teams. So, it's about the product mix getting the high-margin products into the quarter. That's very important for us. And then, on the cost side and on the efficiency side, it's absolutely vital with resilience and excellence initiatives we're driving to become more efficient and get the leverage on SG&A, as we also mentioned at the Capital Markets Day. And I think that's a couple of the key activities we're driving, and also for getting back to the margin expansion.

Okay. Thank you. Thank you. Thank you.

Thank you, Victor.

Thank you, Victor.

And our next question comes from the line of Veronika Dubajova of Goldman Sachs. Please go ahead. Your line is open.

Thank you so much for taking my questions, and I have three. Gustaf, I just wanted to follow up first on this expectation that you have for installation growth year-on-year in the fourth quarter? And I know you've just mentioned that component shortages are reducing, but can you just give us a little bit of insight into what is changing and how substantially it's changing and kind of your degree of confidence? I mean, we're a month through the fourth quarter, which is a very important installation quarter for you guys, over a month now, but just kind of curious sort of what you're seeing and how much visibility you have on this idea that you do indeed see installation growth year-on-year in Q4, how confident you are in that? That's the first question.
My second question is just, if you can help us and I appreciate you don't guide, but if I think about the gross margin building blocks, obviously, the mix was a tailwind this quarter. To the extent that you do see some installation growth in Q4, would you expect that to be a headwind, and so, is there a risk? And I think I asked this question when you preannounced. Is there a risk that the gross margin actually sequentially steps down in Q4, and then only starts to rebound as we move into next year? So, if you have any guidance for us on that, that would be great.

And my third question is on Unity. And what I'm going to ask, probably, you won't answer it, but could you give us an update on where the order count is at the moment, because I don't think we've had it for a couple of quarters and it just would be helpful to know? But more importantly, obviously, we got the data from ViewRay on the [indiscernible] (27:48) trial, the interim readout, and while there seem to be some clinical benefit in the very short term from MRI-guided radiation therapy, this seem to be not statistically significant after three months. So, I'm just curious kind of do you have any thoughts on that, have you looked at that data, what do you think that might mean for some of the clinical work you're hoping to undertake, and how is that informing your reimbursement strategy of Unity? Thank you.

Gustaf Salford
President & Chief Executive Officer, Elekta AB

So, we started with the quarter, and the conference in Q4, if I got the question right, then it was more the risk on the gross margins as you mentioned, Veronika, there was kind of the Unity demand, but also the clinical evidence perspective. So, if I start with installation volumes into the Q4, the demand is there, for sure. I mean, we have customers around the world wanting to have installations of linacs, so I think the demand is absolutely there.

We saw, in Q3, that we had a bit of Omicron, especially maybe December and January headwinds, but then it improved in the end, and we've seen an improvement now as well. So, it's easier to get access to product managers, to hospitals. They're not as many people in quarantine. I think you've heard and seen that in the other medtech companies as well. So, it's easier to plan for those installations. So, that has improved.

But what's currently a challenge and that was the case in Q3 as well, but I think we're mitigating it quite well in Q3, is the component shortages that you go from having it on contract, instead, you need to find it on the spot market. It is more challenging to plan and it's more costly. But we're working through that day-by-day with our supply chain teams to make sure that we can deliver on that higher installation plan in the quarter. So, that's the plan we have and that's what we're driving for.

And then I mentioned, we would like to see the best product mix there as well with more focus on gamma knife high profitability units in the quarter. We had a really good service revenue growth in Q3, but I think we would continue to drive the service business, we will continue to drive the product mix, and also more volume through growth in the number of installations. So, I think that's my perspective on top line growth in Q4 and the gross margin development.

On the risks, I mentioned that a bit on the gross margin side, but what was the question there, Veronika that you wanted to have an answer on?

Veronika Dubajova
Analyst, Goldman Sachs International

Oh, just...
Veronika Dubajova  
Analyst, Goldman Sachs International

Yeah. No, I was more really interested in terms of the sort of fourth quarter gross margin, and I guess, you have tailwinds for more installations, but that's also a headwind in that it's a more diverse mix. And I guess, just the supply components, you said that you are seeing component shortages reducing, do you have visibility for the entire quarter on that or is it just, as you're tracking day-in, day-out, you see you're getting more components, but you don't necessarily have guaranteed volumes for the entirety of the quarter?

Gustaf Salford  
President & Chief Executive Officer, Elekta AB

That's correct. So, you have some components you need to buy in the spot market, and that's a continuous working relationship we have with our suppliers. So, I think that hasn't changed. We're working through it. We have Q4 to take care of what – the message we have from our suppliers and from our partners is that this should improve the component shortages, as we move into the summer and so on. So that's the best available information I have.

On the Unity orders, we are not giving an update. You saw an example in the PowerPoint presentation, but we're not giving a quarterly update on the Unity orders. But we see a very good demand out in the market. We see the conferences. So, we are very optimistic about the continued Unity order growth. And it's tied to your other question, I would say, it's also tied to the clinical evidence, and I think it's best that ViewRay comment on that study. But I think it's positive that we are two players driving this. And you also see that if I refer back to the slide I showed, we start to see these clinical trials, we start to see the superiority studies. You referred to one, but we will see more of those coming in the next couple of years.

So, from the superiority point of view, we're still quite early in the process. But we have done a lot or our customers has done a lot on their clinical safety and effectiveness studies. So, I think we will just continue this development or customers will, and we will support them and we will work a lot on the reimbursement side as well to continue to drive Unity growth and MR-Linac growth over the coming quarters and years.

Veronika Dubajova  
Analyst, Goldman Sachs International

Thanks, Gustaf. That's helpful. I mean, let me maybe ask the Unity question slightly differently. I guess, do you think you would be able to obtain better reimbursement, if you are only able to prove a short-term benefit from MRI radiation therapy?

Gustaf Salford  
President & Chief Executive Officer, Elekta AB

I think we need to see more superiority studies. I think that's the key. This will not just be based on one study. It's something we drive on a very broad scale. And we need to have those studies and many of those are ongoing as we speak. And that will be the basis for driving higher reimbursement around the world and those discussions we're having as we speak. So, again, I'm very positive and optimistic on the higher reimbursement levels based on those studies.
Veronika Dubajova
Analyst, Goldman Sachs International

Understood. Thank you, guys.

Gustaf Salford
President & Chief Executive Officer, Elekta AB

Thank you.

Operator: Thank you. And our next question comes from the line of Kristofer Liljeberg of Carnegie. Please go ahead. Your line is open.

Kristofer Liljeberg-Svensson
Analyst, Carnegie Investment Bank AB

Thank you. Surprise, surprise, I'm coming back to the gross margin here. So, you continue to compare year-over-year, and I think you said approximately the same amount on negative impact, but now, you’re comparing with the third quarter, which was already a weak margin last year. And last quarter, you compared with the second quarter, which was much better margin quarter. So, the question is, what's the baseline here and what is really required for you to get back to 40% margin? That's my first question.

Then, I just want to clarify if your view is that the volume effect in the fourth quarter, assuming installations will pick up, will be more positive for the gross margin than the negative effect from service revenues then potentially being a lower proportion of sales?

And my third question also relating to cost, but operating cost, you saw a sequential increase in both selling and administration cost, so is this the new normal level now with more activity, and do you see less net operating cost to remain below the pre-pandemic level, as you have said before? Thank you.

Gustaf Salford
President & Chief Executive Officer, Elekta AB

Thank you, Kristofer. To your first question on the gross margin development, we thought it was important just for clarity to compare to the quarter last year. But I agree, the 38.7% was also low. Compared to the year before, that was quite high because of low COVID-related activities and, therefore, low expenses. So, what happened a year ago was a lot of service activities. We went out again to the installed base software, done almost everything remotely for the first quarters in the COVID pandemic. And then, we came to the 38.7% and then what happens between last Q3 and this Q3 is really about the logistics cost and the supply chain lead times that has been extended, as we mentioned.

I believe that the quarter in the year before was high service costs in that quarter and that has normalized from that point of view, because we needed to do a push in Q3 last year to get out to our customers again. And now, we see the logistics cost that we see, from a long-term perspective, more as temporary. And we see a gradual improvement of our margins going forward when we see the lower logistics costs and a better balance in the system. So, I think it's those two effects. And I'm going back to the Capital Markets Day that historically on a yearly basis, Elekta has been around 41% gross margins. On the product...

Kristofer Liljeberg-Svensson
Analyst, Carnegie Investment Bank AB
Could I – sorry.

**Gustaf Salford**  
President & Chief Executive Officer, Elekta AB

Yeah. Sorry. Yeah.

**Kristofer Liljeberg-Svensson**  
Analyst, Carnegie Investment Bank AB

Could I just stop you there. But you didn't mention on the slides [indiscernible] (37:14) doing service as a tailwind this quarter. I guess, that's sort of benefit to the margin year-over-year.

**Gustaf Salford**  
President & Chief Executive Officer, Elekta AB

Yes, we didn't, but these were the key drivers versus last year. It was this higher logistics costs and longer supply chain lead times. We see logistics costs being very high to this installed base, and that's service cost as well to get down to the spare parts and so on to ship them out. And then going forward, when we get to a more normalized situation, we will have the benefit from more remote servicing of our installed base and also less costs for the higher logistics costs that we see today. So, I think we have those two tailwinds going forward.

On the product mix question, we have the plan for growth on the installation side. I mentioned better product mix, and then relatively on the service/solution mix, that will then – we expect solutions to grow faster, of course, than they did in the Q3. So, that's the three key main drivers on the gross margin development in Q4 as I said.

**Kristofer Liljeberg-Svensson**  
Analyst, Carnegie Investment Bank AB

But do you think the volume effect is going to be loaded on the negative effect from a lot of proportional solutions in the fourth quarter?

**Gustaf Salford**  
President & Chief Executive Officer, Elekta AB

That depends a lot on what product mix comes into the quarter that I mentioned before. But like-for-like, yes, it'd be lower, but we're driving for such a more profitable product mix with Neuro and, for example, software in the fourth quarter. So, that's the plan.

**Kristofer Liljeberg-Svensson**  
Analyst, Carnegie Investment Bank AB

Okay. Thank you.

**Gustaf Salford**  
President & Chief Executive Officer, Elekta AB

And then you had one question, I think, on the SG&A expenses that we have, over the last year, seen a good leverage on. We expect we're doing some investments now for optimization, digitalization on the admin cost and the IT cost, and I think that will pay off in our resilience and excellence program. And the key topic is really to get back to leverage on SG&A as a percentage of revenue over the coming quarter. So, that's the key ambition now. And also bring in some of the benefits we saw from what we learned through COVID in the digitalization of our sales, marketing, and administrative processes and taking that with us post-COVID.
Kristofer Liljeberg-Svensson  
**Analyst, Carnegie Investment Bank AB**

The investments on the administration cost line, for how long will they continue? I think it was the highest level ever for administration cost in the quarter.

Gustaf Salford  
**President & Chief Executive Officer, Elekta AB**

Yeah, we saw that. We did some investments now on the IT side to support these programs. So, we see it as high level at the moment.

Kristofer Liljeberg-Svensson  
**Analyst, Carnegie Investment Bank AB**

But will it continue in Q4, Q1?

Gustaf Salford  
**President & Chief Executive Officer, Elekta AB**

We'll update you on that going forward, but ambition is, of course, with the excellence program, to address the administrative cost as well.

Kristofer Liljeberg-Svensson  
**Analyst, Carnegie Investment Bank AB**

Okay. Thank you.


Karl Norén  
**Analyst, Danske Bank A/S (Sweden)**

Yes. Good morning. So, I have three questions. We can start off with a question on the pricing side and when you expect to fully compensate for this increased costs? I mean, of course, we expect some of this to be temporary, but it would just be interesting to hear your thoughts on your visibility and when you expect to fully compensate for the higher cost, if we assume that they stay on today's high levels?

And then on investments, I mean, you capitalized quite a lot now during the last couple of quarters, I was curious to hear what you are developing and if you could elaborate a bit on these new products and software, and whether they will drive revenue growth in the near term?

And then, just lastly a question on China, where you stated that the order growth has been a bit weaker during the last quarter or months. Could you just explain a bit more on the softness there, and how long do you expect it to remain for and if it's internally or market driven? Thank you.

Gustaf Salford  
**President & Chief Executive Officer, Elekta AB**

Absolutely. So, pricing investments in R&D was my understanding of the question, and then the China slowdown in the last month. So, if we start with pricing, as mentioned before, 40% of our revenue is service contracts. The
absolute majority of those are linked to index clauses, we call it, CPI clauses, that's with the inflation in country, that we adjust them year over year. If we take the new orders we sell, we have also adjusted the prices to have the right price due to inflation, and we have also done a lot of efforts during the last year on value pricing and pricing excellence, and we've also seen more of the SaaS model and value-added services models that has a positive impact on the overall price. So, we're doing a lot of activities in those areas. We're also, when possible, taking the discussions with the customers on logistics costs that are very high at the moment to address that price increase as well. So, I think that's the key areas we're driving on the pricing side...

[indiscernible] (43:04)

Karl Norén  
**Analyst, Danske Bank A/S (Sweden)**

...follow up on the service side there with the CPI clauses and if it's possible to say anything, because I guess that your costs for doing service when you have, to some extent, global teams, et cetera, has been higher than the CPI adjustments, is that a correct assumption?

Gustaf Salford  
**President & Chief Executive Officer, Elekta AB**

I think based on, I mean, the logistics costs, but if you look at the labor, that's quite a big part of the, if you say, COGS for service contracts, that's more lagging inflation. But we see, there will be impact of that as well. And that is what we counter then with CPI aspects and component shortages with the spare parts that we need for the service business that we also need to do to CPI clauses for...

Karl Norén  
**Analyst, Danske Bank A/S (Sweden)**

Okay.

Gustaf Salford  
**President & Chief Executive Officer, Elekta AB**

...But the current impact you see in the morning that we also discussed on the supply chain and logistics costs, that I see more as a temporary effect that will be reduced over time as we move forward. But pricing is a very important topic for us right now. But, in the industry, it's also, of course, extremely important to launch new products, as we're doing with, for example, Harmony and get the price realization on that new innovation. And that's going well based on the Harmony launch that we did a little bit more than a year ago.

On the investment side, there's three key areas called – it's the family of linacs, as we call it. So, you know that we launched Harmony quite recently, but it's also continuing with the Linac platforms that we're investing in. It is the Unity platform, as we say. And Unity is truly a platform that we can bring so much new functionality and innovation on going forward, and that will continue for many years. And with the magnet collaboration we have with Philips, it's also to bring new innovations on the MR side into Unity going forward.

We are also doing the software underlying platform and I mentioned that to probably many of you that we have invested in significant development on the underlying software platform that we would place all our new software on and all the modules linked to our linacs and Unity and brachytherapy and gamma knives. So, that's a big investment for Elekta to build that underlying platform, and we have done that now for around two years, and we'll continue to invest in that area. So that's the three key investment areas for Elekta on the innovation side. The benefits will come throughout the next couple of years, and I think it's important part of our ACCESS 2025
strategy, is kind of accelerating innovation that we have been doing and you see it in the higher gross R&D. And we are investing in many parts of the world to drive those three areas that I mentioned.

China, slowing down China, I think many companies have seen that during, say, December-January due to the Olympics, due to quite tough lockdowns, and so on or quarantine rules, we've seen a bit of a slowdown on the Chinese market. Our data tells us that we take market share. We have seen more information about kind of the five years plans and investment in cancer care going forward. And as you know, we are very well-positioned in China, but we saw a couple of months of slower order growth and a slower market, but I expect it to pick up over the coming quarters. Yeah.

Karl Norén
Analyst, Danske Bank A/S (Sweden)

Okay. Thank you.

Gustaf Salford
President & Chief Executive Officer, Elekta AB

Thank you.

Operator: Thank you. Our next question comes from the line of Rickard Anderkrans of Handelsbanken. Please go ahead. Your line is open.

Rickard Anderkrans
Analyst, Svenska Handelsbanken AB

Hi, and thank you for taking my question. Only one from my side, actually. So, you emphasized in the report that your backlog is at record high level by the end of the quarter. But if we go back and convert the backlog to USD, just as an example, by the end of each quarter, it appears rather flattish for the last few quarters here. And in light of this FX adjustment, can you help me understand what this implies for your business climate since, I guess, you book more orders in USD and as well as euros, for example, rather than Swedish krona, just to try to understand the underlying dynamics there?

Gustaf Salford
President & Chief Executive Officer, Elekta AB

Yeah. Thank you, Rickard. So, I think around 50% of our business is in US dollars, not just because the US market is one of our biggest markets, but we sell in US dollars to many emerging markets as well. So, 50%, roughly say around 30% is euros. So, that's the two key currencies for Elekta. So, I haven't fully done that conversion you have done to dollars. We focus on SEK. But what you can see is that the order growth has been there for the last five quarters, and we have a very strong order backlog to deliver from.

We often say that the order we get has 1 to 1.5 years average time between the order taking to the revenue installation date. So, quite a lot of the revenue volume, so to say, for next fiscal year the absolute majority, we have in the backlog. And that's why I'm also saying, Rickard, that it's really about transforming order backlog to revenue, that's one of our key priorities for the coming quarter, Q4 and also next fiscal year to support the growth. So, I see it as a growing backlog, and I see it as a very healthy backlog to deliver from for the next couple of years.
Rickard Anderkrans
Analyst, Svenska Handelsbanken AB

Thank you. That's very helpful. That's all from me, actually. Thank you.

Gustaf Salford
President & Chief Executive Officer, Elekta AB

Thank you, Rickard.

Operator: Thank you. We have one further question in the queue. [Operator Instructions] And the next person is David Adlington at JPMorgan. Please go ahead. Your line is open.

David Adlington
Analyst, JPMorgan Securities Plc

Hey, guys. Thanks [indiscernible] (49:34) questions. I've got three, please. So, just coming back to the R&D capitalization, which obviously is pretty elevated, I'm just wondering what the outlook for your capitalization, absolute rates and amortization rates are from here and what point will the amortization start to come through and hit your P&L and, therefore, the implications for margins?

Secondly, just on the competitive environment, I'm just wondering if you are seeing any changes in how Varian is able to compete with you? It seems like they're making some progress with better access to the C-suite, and also, they've also announced a new European manufacturing plant, I wondered that had any impacts for you as well?

And then final one, just for today, just wondering what your exposure to Russian-Ukraine was, please?

Gustaf Salford
President & Chief Executive Officer, Elekta AB

No, absolutely. Thank you for that. So, I think, as Tobias said on the capitalization amortization schedules we had planned, it's quite similar to what we presented at the Capital Markets Day. So, we were expecting higher gross R&D due to these three key investment programs we're driving. We also expected amortization to go down, because we have been amortizing a lot on the Unity over the last three years, a little bit more than three years now, and we have some bit of that still to go, but less. And then you'll see smaller products, let's say, smaller investments coming out, like Harmony, like [ph] Mosaic 3 (51:03).

So, you will see more steady amortization rates going forward and that's what we also described that net earning, gross R&D should harmonize over time, but at the moment, gross R&D is a bit higher. And then we can also say, compared to what we believed at the Capital Markets Day in June, the revenue growth has been lower compared to the plan we have there. So, then we have a bit higher gross R&D as a percentage of sales, compared to what we described in June. So, that's the dynamics. And going forward, we see quite high levels now in Q4 as well on the capitalization side, but it will harmonize as we go into the next year as described.

Competitive situation. I truly believe in Elekta strategy as the standalone focused radiation oncology or radiation therapy player. I think that with strong partnerships is very important, say like with Philips, and it enabled us to be flexible on how we work with partners, but at the same time, very, very focused on our customers in the radiation therapy field. I think Varian is taking a – or Healthineers is taking a different approach, more larger deals, more integrated, but I think Elekta's kind of DNA, and how we always been driving is to be agnostic partner, mix sites, and have the right software solutions and device solutions for those sites.
And from my point of view, I think it's two different models. I truly believe in our model, and we will drive that successfully going forward as well. I think what I see is, it's quite a significant integration of Healthineers and Varian around the globe and I think they're driving forward for the synergies, both on the revenue side and the cost side that they were referring to when the deal was announced. I think that's what I can say about the competitive dynamics right now.

On Russia, of course, we're following the development in Ukraine and Russia, and that's a tragedy, of course. But for Elekta's perspective, we are following the development, we are trying to install and service the machines that we have around those two countries, because I mean, our priority is always the cancer patients. But at the same time, Russia is a small market for us, if you think about sanctions and so on. It is around 1% of the total Elekta business. So, it's not the significant part of our revenue or margin coming from the Russian market. But we're following the developments, we're following with our partners and distributors in the market, and also our local teams. So, that's the current situation right now.

David Adlington
Analyst, JPMorgan Securities Plc

That's great. Thank you.

Operator: Thank you. And we've had one further question come through and that's a follow-up Veronika Dubajova at Goldman Sachs. Please go ahead. Your line is open.

Veronika Dubajova
Analyst, Goldman Sachs International

Excellent. Thank you. I figured if you had time, I'd squeeze it in. Just wanted to get an update on Harmony? And, Gustaf, if you can maybe talk to, give us a sense of how important that has been in terms of the order growth, and then the type of customer that is interested in the device, where have you seen the most demand and the most success with that product? Thank you.

Gustaf Salford
President & Chief Executive Officer, Elekta AB

Thank you, Veronika. No, we're super excited by Harmony. I mean, it's two different levels of Harmony, Harmony and Harmony Pro. So, it's a suitable product for both, I mean, high-end cancer clinics, and we've seen examples at the high-end university clinics having it as, maybe not the first linac, but maybe to have it next to Versa HD, and then it will become very flexible in what kind of cases you can treat. It's also, of course, for emerging markets around the world, because you get a very good machine for high throughput, but you also have very high productivity, and also you can do quite complex cases with the Harmony and Harmony Pro.

So, we see both those kind of customer segments; the emerging market segment that's important for us, but also around Europe. And we all have, also after ASTRO, entered into US and get good interest in US as well. So, I think it's quite a broader launch around the world with Harmony, and good interest also for these two segments. And we also see great patient volume. So, it's really delivering on that promise to have high throughput of patients in many of those Harmony sites. So, I think that's just a brief update on the Harmony launch.

Veronika Dubajova
Analyst, Goldman Sachs International

Any chance if you can tell us how many orders you have had for it so far?
Gustaf Salford  
*President & Chief Executive Officer, Elekta AB*

Yeah. We have said that we shouldn’t disclose any specific number of orders every quarter, but we’ll give updates going forward. Absolutely.

Veronika Dubajova  
*Analyst, Goldman Sachs International*

Okay. Yeah, I mean, if you can?

Gustaf Salford  
*President & Chief Executive Officer, Elekta AB*

As we would do with Unity as well.

Veronika Dubajova  
*Analyst, Goldman Sachs International*

Yeah. Just the active date number at some point in time, maybe with full year would be really helpful for both of those.

Gustaf Salford  
*President & Chief Executive Officer, Elekta AB*

Yeah. Understood.

Veronika Dubajova  
*Analyst, Goldman Sachs International*

Thanks.

Cecilia Ketels  
*Head-Investor Relations, Elekta AB*

Okay. Okay, we have reached the hour. So, thank you very much for participating in this call. And if you have any further questions that you didn’t have time to ask in this call, please don’t hesitate to reach out to me or my colleague. Well, thanks and have a good remaining Thursday. Bye-bye.

Tobias Hägglöv  
*Chief Financial Officer, Elekta AB*

Thank you. Bye-bye.

Gustaf Salford  
*President & Chief Executive Officer, Elekta AB*

Thank you.