

FINAL TRANSCRIPT

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MDZ - Q2 2010 MDS Inc. Earnings Conference Call

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MDS Inc. - Director IR

Steve West

MDS Inc. - CEO

Peter Dans

MDS Inc. - SVP, CFO

CONFERENCE CALL PARTICIPANTS

Dave Windley

Jefferies & Company - Analyst

Douglas Miehm

RBC Capital Markets - Analyst

PRESENTATION

Operator

Good morning, ladies and gentlemen. Welcome to the MDS second quarter results conference call. I would now like to turn the meeting over to Ms. Ana Raman. Please go ahead, Ms. Raman.

Ana Raman - MDS Inc. - Director IR

Thank you and good morning, and welcome to MDS's second quarter conference call and webcast. On the call this morning are our chief executive officer, Steve West, and our Senior Vice President and Chief Financial Officer, Peter Dans. The format for our call will be that Steve and Peter will provide their perspectives and then we'll open up the lines for questions to analysts. Please note today's comments contain forward-looking information, so actual results may differ materially from expected results because of various risk factors. These factors are described in MDS's quarterly release and annual filings, which are available on SEDAR, Edgar, and the Company's website. Results have been prepared under US GAAP and all amounts mentioned are in US dollars, except when otherwise noted. Our unaudited news release discussing highlights of our 2010 second quarter results was issued yesterday after market close. If you have not received a copy, it is posted on our website at MDS Nordion.com. You will also find a copy of our unaudited second quarter's management's discussion and analysis and financial statements and notes on our website. All documents were filed yesterday after market close. With that, I'll turn it over to Steve.

Steve West - MDS Inc. - CEO

Thank you, Ana, and good morning to everyone who has joined us today. With the completion of the sales of both MDS Analytical Technologies and MDS Pharma Services the Company has reported the results for these businesses as discontinued operations. I will speak to continuing operations, which include Nordion and Corporate functions, and Peter Dans will address discontinued operations and now financial results.

Starting with continuing operations, for the second quarter, MDS reported revenues of \$56 million compared with \$65 million in the corresponding period last year. Excluding the impact of foreign exchange, revenues decreased by 23%, primarily driven by the isotope shortage. We reported a loss from continuing operations of \$52 million, which included significant impacts related to our strategic repositioning, including a \$14 million after-tax corporate restructuring charge and a non-cash \$27 million foreign exchange revaluation. We ended the quarter with a cash balance of \$134 million compared with \$871 million in the



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prior quarter, primarily as a result of our distribution to shareholders of \$450 million for our planned substantial issuer bid and the \$223 million repayment of unsecured senior notes.

Now let me address the Nordion results. Despite the isotope supply shortage, Nordion results were positively impacted by increased Cobalt volumes and strength in the radiotherapeutics operations, which were largely driven by TheraSphere our targeted liver cancer treatment. On the medical isotope supply front, we are currently focused on the NRU's return to service, currently anticipated by CL to be the end of July 2010. In preparation, we have examined our facilities and made modifications and upgrades as required. We have prepared our employees with additional training and communicated to our global supply chain a ready-to-ship and supply action plan. As part of our return to service plan, we are also working closely with a customer base to solidify supply arrangements and communicate anticipated product supply information. We believe we have taken the steps necessary to assume our role in the supply chain and resume the processing of isotopes from the NRU with the global Nuclear Medicine Community.

In terms of our legal proceedings against ACL and the government of Canada, our primary focus remains on the confidential arbitration process. Hearings for the arbitration are still scheduled beginning the fall of 2010, and our expectation now is that they will continue into the second half of our fiscal 2011 year with a decision from the panel following the conclusion of the hearings.

Now let's take a look at the progress made with the strategic repositioning of MDS. On February 3, 2010, MDS repaid in full its remaining outstanding senior unsecured notes of \$223 million. On March the 5, 2010, MDS completed the divestiture of the MDS Pharma Services Early Stage for \$45 million, including a \$25 million note and a 15% minority interest in one of the acquiring entities. On March 29, 2010, MDS repurchased and canceled more than 40% of its outstanding Common shares at a purchase price of \$8.50 per Common share for a total cost of \$450 million under a substantial issuer bid. MDS continues to track to our strategic repositioning plan. The provision of transitional services to the businesses the Company has sold is ongoing and the Company expects to see the impact of the strategic repositioning on its financial results into fiscal 2011.

As we continue to complete the transition from MDS to a strong and resilient Nordion, my attention is focused on the following activities. Reducing the ongoing corporate overhead and consolidating corporate functions at Nordion's Ottawa headquarters by the end of 2010. We focused on being fully prepared to resume the supply of reactor isotopes with the expectation that the NRU reactor will return to service at the end of July 2010, and we are supporting the growth of our sterilization technologies and radio pharmaceutical products.

The Nuclear Medicine industry has undergone significant shifts involving reactor supply chain dynamics and medical isotopes usage. The world has come to understand the fragility of the global aging fleet of nuclear reactors that supply medical isotopes. And the focus on medical isotopes supply has become much more permanent as countries look to opportunities for domestic supply and the industry looks for new methods to use medical isotopes. For sometime now we have recognized this new dynamic and have been assessing a number of alternatives to address this changing environment. We continue to evaluate a series of medium and long-term medical isotope supply options to provide a secure supply chain for the future. Following the anticipated NRU and pattern reactor restarts, we expect to be in a better position to assess the current view of the industry. Once we have reestablished our position in the industry, we plan to maintain our focus on the issues of medium and long-term isotopes supply. Equally, we believe that Nordion can leverage its solid position and core competencies in our sterilization technologies and build on the more recent momentum in our TheraSphere and other radiopharmaceutical products to deliver positive financial returns.

Now, I would like to hand it over to Peter Dans, who will provide a more detailed view of our financials and then we will begin the Q&A session. Thank you for your time. Peter.



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Peter Dans - MDS Inc. - SVP, CFO

Thanks, Steve, and good morning, everyone. As Steve mentioned, please note the continuing operations includes our MDS Nordion business and corporate functions. And discontinued operations include Analytical Technologies and Pharma Services. I will start with the summary of the results from continuing operations. For MDS Inc., total Q2 revenue was \$56 million, down 14% from \$65 million last year, excluding the impact of foreign exchange, revenue declined 23%, mainly driven by the isotope shortage. In the quarter, we reported a loss from continuing operations of \$52 million compared to a loss of \$6 million last year. Our loss per share from continuing operations was \$0.51 in Q2 2010 compared to a loss of \$0.06 per share last year.

Now for the Nordion segment, revenue declined from \$65 million in the second quarter last year to \$56 million in 2010, primarily driven by the decrease in medical imaging revenues, mainly due to the impact of the continued shutdown of the NRU reactor. The decrease was partially offset by the positive impact of foreign exchange, higher volumes with Cobalt, as well as pricing initiatives. Nordion also experienced an increase in revenues in Q2 from the sales of its cyclotron isotopes, as customers substituted product during the current shortage of reactor-based medical isotopes. Also in the second quarter, we saw global growth in radio therapeutics, led by TheraSphere, which grew by more than 40% on a year-over-year basis.

Q2 revenue from sterilization technologies was 24% higher than in the same quarter last year, due to an increase in Cobalt shipments. Cobalt revenue was higher on a sequential basis when compared with the first quarter of 2010, mainly due to the timing of Cobalt delivery from suppliers. We continue to expect Cobalt volumes to be higher in fiscal 2010 than in 2009. The amount of Cobalt shipped in each quarter, however, is expected to continue to fluctuate based on the timing of Cobalt delivery from suppliers and the timing of customer requirements. In Q3, we expect Cobalt revenue to be lower than our second quarter, followed by higher revenue in the fourth quarter.

Second quarter gross margins decreased 51 -- from 51% in 2009 to 43% this year, primarily due to the impact of the NRU. Nordion's SG&A expense for the second quarter was 12 million, flat compared to the same quarter last year. This quarter, the embedded derivative related to our long-term Russian supply contracts resulted in a gain of \$1 million compared with the \$3 million gain in the second quarter of 2009.

Depreciation and amortization for Nordion was \$4 million in Q2, up \$1 million over the same quarter last year. Nordion's operating income was \$9 million in Q2, down from \$20 million in the same quarter last year. The decline in operating income was primarily due to the lower revenues for medical isotopes, which were partially offset by growth in Cobalt revenues and other products.

Now I will discuss corporate and other. The corporate and other operating loss was \$61 million in Q2 compared to a \$12 million loss in 2009. The increase in loss was primarily due to foreign exchange losses, higher restructuring charges, and SG&A and depreciation and amortization expense. We recorded a \$27 million non-cash foreign exchange loss in the second quarter, which resulted primarily from the revaluation of \$450 million in proceeds from the sale of MDS Analytical Technologies. The proceeds were held in US dollars to fund the substantial issuer bid, which was paid out in US dollars. While this did not create an exposure from a US dollar perspective, the cash proceeds were received and held in a Canadian functional currency entity. As the Canadian dollar strengthened against the US dollar during second quarter, our non-cash loss on foreign exchange was recorded.

Over restructure charges for the second quarter were \$18 million, which included additional transaction incentive payments, financial advisory fees, and additional severance costs. These items were related to the strategic repositioning. SG&A expense of \$17 million in Q2 was up \$9 million compared with the prior year, due to an increase related to directors and officers insurance associated with the period prior to the completion of the substantial issuer bid. Higher incentive costs and an unfavorable foreign exchange impact. These expenses were partially impacted by a smaller work force in Toronto as we continue to wind down that office.

SG&A also included costs related to transition services being provided in the Analytical Technologies and Pharma Services businesses that were sold for which \$5 million of income was reported in other expense. Following the completion of transition activities with the strategic repositioning, including the wind down of our Toronto office, we continue to expect SG&A for



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corporate and other to be approximately \$3 million per quarter. MDS had income tax expense of \$1 million in the second quarter. Because we were unable to recognize tax benefits related to the foreign exchange losses, along with certain other operating losses outside of Canada. At the end of the second quarter, we had \$73 million of net deferred tax assets, which are available to reduce cash income taxes in the future.

Now I will turn to discontinued operations. In Q2, we reported a loss from discontinued operations of \$38 million compared to a loss of \$11 million in 2009. At the end of Q2, a total after-tax loss of \$74 million was recorded on the sale of Early Stage, with \$11 million recorded in the second quarter. We expect to finalize the loss on the sale for final closing adjustments during fiscal 2010. We reported a \$20 million operating loss for Early Stage in the second quarter, primarily as a result of operating performance leading up to the close of sale on March 5 and the wind down of the Montreal operations. The loss also included a \$4 million restructuring charge and a \$12 million foreign exchange loss related to the settlement of an intercompany loan and the reevaluation of certain assets and liabilities. The loss was partially offset by a \$7 million reversal in the FDA provision based upon a revised estimate for future costs. The loss from Analytical Technologies was \$7 million compared to a loss of nil in 2009. We continue to expect final proceeds from the sale of Analytical Technologies to approximate the carrying value of the business. We expect that there may be additional post close adjustments related to both the sale of Analytical Technologies and Early Stage that may affect both the gain loss calculation and the future cash flows associated with the transactions.

Finally, turning to cash flow, in the second quarter of 2010, MDS completed its substantial issuer bid distributing \$450 million of cash to shareholders. Under the bid, 44% of the Common, outstanding Common shares were repurchased and cancelled at a purchase price of \$8.50 per share. The shares were repurchased using some of the proceeds of the sale from Analytical Technologies. MDS also used \$223 million to repay our senior unsecured notes, including the associated make hold payment of \$23 million. With the repayment of these notes, MDS had no debt on its balance sheet, except for the government of Canada loan, which is fully offset by a funded financial instrument. Other cash items for the quarter include a \$55 million in transaction and restructuring costs and the net proceeds from the Early Stage transaction of \$13 million.

At the end of the second quarter of 2010, our cash balance was \$134 million, not including restricted cash. We currently expect an additional \$40 million of transaction and restructuring costs to be paid out during 2010, primarily related to severance and financial advisory service fees. In addition, we expect to receive \$5 million based on our current estimate of the net aggregate impact of adjustments and amounts relating to the divestitures. We believe we have a solid cash position to support the ongoing operations and obligations, including those retained and related to the businesses we have sold. That concludes my financial comments for the fourth quarter.

Before I ask the operator to open the lines for Q&A, I would like to ask you to limit yourself to one primary and one follow-up question. Now, operator, would you please open the lines for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will be from Dave Windley from Jefferies & Company. Please go ahead.

Dave Windley - Jefferies & Company - Analyst

Thanks for taking my questions. First of all, Steve, I was hoping you could comment on what you see the pricing environment looking like for [Mollie], and how, my understanding is the price has escalated fairly significantly, and I'm wondering how sticky you think that might be. So first question, what is the change in price since NRU went down and how sticky do you think that would be?



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Steve West - MDS Inc. - CEO

Good morning, Dave. Thanks for that question. I think that's a good question. A lot of people are asking that. And of course I'm going to say as you know right now, we're not operating in the market. So as far as current pricing is concerned, our visibility is probably the same as yours. Clearly there's a lot of investment that's going into the existing facilities, into NRU and patent, that definitely will be pushing prices upward. And then I think there is a lot of discussions going on about investing in new facilities as well. So there's absolutely no doubt that there is going to be an upward momentum on pricing. How that plays out, though, I think at the moment we'll have to see. We are working with our customers on the renewed supply chain going forward, and once we get more clarity on that NRU restart, then I think we'll be able to finalize those relationships and probably we'll get a bit more visibility on how the, how things will shake out. So as to how long the pricing will stick, generally we have contractual relationships with our customers, but as always, pricing is always going to be driven as a combination of supply and demand.

Dave Windley - Jefferies & Company - Analyst

Second question, then, sticking with price and moving to other parts of the business, wondering if you could break out the contribution of price versus volume to your growth in the Cobalt and TheraSphere revenue lines?

Steve West - MDS Inc. - CEO

Well, we don't, we don't break out that level of detail. We don't normally disclose that, Dave. I think Cobalt is a mature business, so generally we, we've always indicated it's sort of lowish modest single-digit growth industry, driven by demand in medical devices. I think you only see there a combination of volume and pricing growth that takes place over the long-term. As far as TheraSphere is concerned, it's a more complicated situation because it's -- there is a reimbursement driver there. So what we have seen is I think very decent growth in TheraSphere, year-over-year 40%, which is, primarily driven by volume, Dave. In reimbursements, we work on. It varies by jurisdiction, so pricing, therefore, varies by jurisdiction, particularly of course in Europe, because it's not a homogenous reimbursement environment. We're seeing very good growth globally in TheraSphere, that sort of order.

Dave Windley - Jefferies & Company - Analyst

Okay, thank you.

Steve West - MDS Inc. - CEO

Thank you.

Operator

Thank you. (Operator Instructions) The next question will be from Douglas Miehme from RBC Capital Markets. Please go ahead.

Douglas Miehme - RBC Capital Markets - Analyst

Thank you. First question just has to do with corporate costs, and can you tell us of that \$17 million, how much of that was related to the TSAs?

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Peter Dans - MDS Inc. - SVP, CFO

We don't break it out specifically. Again, we did highlight that we received approximately \$5 million of income associated with the TSA. So in essence, that's to offset the costs we incur in SG&A.

Douglas Miehm - RBC Capital Markets - Analyst

So it's effectively a wash, then?

Peter Dans - MDS Inc. - SVP, CFO

Again, we haven't gotten into the specifics, but it's essentially a wash.

Douglas Miehm - RBC Capital Markets - Analyst

Okay. So then if we look at the quarter ex- let's say it's \$5 million just for the sake of argument. You've got \$12 million and you're going to be taking that down to \$3 million, I believe. Could you walk us through the components of that differential that you expect to take down between now and next year?

Peter Dans - MDS Inc. - SVP, CFO

There again, I probably can't fully reconcile it, but there are -- there were some costs in the quarter that were unique to the quarter such as the -- we highlighted the directors and officers insurance, which we recorded, which related to the period really prior to the substantial issuer bid. We're also still carrying a number of costs associated with our infrastructure and IT, which we expect to wind down. And the other thing is we're -- at the same time as we're ramping down in Toronto, we're ramping up in the Ottawa office. So we do have at this point in time a bit of overlap in terms of functional costs.

Douglas Miehm - RBC Capital Markets - Analyst

So you remain confident that you're going to be able to get to \$3 million?

Peter Dans - MDS Inc. - SVP, CFO

Yes. Again, we reiterated our guidance that we continue to believe we're going to get to the level of approximately \$3 million per quarter.

Douglas Miehm - RBC Capital Markets - Analyst

Okay, and then maybe just for Steve, my follow-up question is can you walk us through the process between now and July, when -- and are you supposed to produce isotopes that will allow them to do that from where we are today?

Steve West - MDS Inc. - CEO

I'll do my best. So I think first of all, on the supply side we -- ACL continued to work on the repairs, assuming that that goes according to the schedule that they have indicated. I think the next big milestone actually will be the hearing with the CNSC. And I think that we would expect would be very soon, probably either at the end of this month or the beginning of next month. That's a critical milestone, I think, because during that time, ACL will present its renewed operating and safety case. Following

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that, ACL will be charging the reactor with heavy water and then fueling the reactor. And we are working with them on, as they progress towards that July date we start to get more visibility around the specifics of how they will be refueling the reactor, when they will be putting in the targets and the rods and when we will be expecting to receive the first shipment of isotopes and how much we would receive for processing. So that's, that's pretty much it. I mean that's a very high level description. There's lots of work going on right now between ourselves and the operating folks at Chalk River around the specifics of how that's all going to take place. Then of course we're working with our customers, giving them some visibility on, as we get closer to that timeframe, as you know, this is a just-in-time business, we'll be able to give them a more crystallized view and understand a little bit more about their requirements sort of on a week-to-week basis.

Douglas Miehm - *RBC Capital Markets - Analyst*

Okay, thank you, Steve. That was helpful.

Steve West - *MDS Inc. - CEO*

Thank you.

Operator

Thank you. We have a follow-up question from Dave Windley with Jefferies & Company.

Dave Windley - *Jefferies & Company - Analyst*

Thanks for letting me come back in that quickly. Thank you. A couple of questions on the cost side, maybe for Peter, on the litigation costs that you may be incurring, I'm wondering if you can quantify that and help me to know where those will be recorded, at the corporate, or what line would those show up in?

Peter Dans - *MDS Inc. - SVP, CFO*

So the costs for the litigation are included in our results. They are in the Nordion segment.

Dave Windley - *Jefferies & Company - Analyst*

Okay.

Peter Dans - *MDS Inc. - SVP, CFO*

Included in the SG&A line.

Dave Windley - *Jefferies & Company - Analyst*

Can you put a number on those, Peter?

Peter Dans - *MDS Inc. - SVP, CFO*

Again, hasn't been that material a number at this point, but--.

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Dave Windley - *Jefferies & Company - Analyst*

Really?

Peter Dans - *MDS Inc. - SVP, CFO*

Continue to incur them on kind of a quarterly basis.

Dave Windley - *Jefferies & Company - Analyst*

So talking less than a couple million dollars?

Peter Dans - *MDS Inc. - SVP, CFO*

Yes, not that range. Per quarter.

Dave Windley - *Jefferies & Company - Analyst*

Right, okay. And then on the pension, I think you mentioned that you've -- you expect to incur some funding costs in the \$4 million to \$5 million range for several more years. Am I -- are those -- I guess is that a continuation of an existing run rate, or is that new expense that you expect to have to incur? And perhaps you could just provide some color around that.

Peter Dans - *MDS Inc. - SVP, CFO*

Yes, for that, it's more from a funding perspective than an expense perspective. But it is incremental cash flow that we could have to incur. Again, there is a potential that we could issue an LC to meet the funding requirements, but again, at this point in time, we're required to collateralize our LC, so it would still be a cash outflow from that perspective. So this is really incremental funding that's been driven by both a decline in equity markets over the past couple of years since we last did our actuarial report, as well as the decline in, in real interest rates, which affect the plan as it's an indexed plan.

Dave Windley - *Jefferies & Company - Analyst*

But that additional funding would not be considered pension expense on the P&L?

Peter Dans - *MDS Inc. - SVP, CFO*

It's not directly. The \$4 million to \$5 million we were talking about was from a cash perspective. We'll need to work through the accounting side of it again. So the disclosure related to the cash funding.

Dave Windley - *Jefferies & Company - Analyst*

Okay, okay, and if I could just sneak in once more since nobody else jumped in, the research and development I believe was a very small number, maybe zero in the quarter. I wonder what you expect that to be going forward?

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Peter Dans - MDS Inc. - SVP, CFO

So historically, we've tended to run at approximately a \$1 million a quarter. The one thing we have highlighted is we continue to look at investments, particularly in the TheraSphere products. So as we look at our trial programs, et cetera, around TheraSphere to drive future growth, et cetera, we may see that line move up somewhat. But again, historically it's sort of ran around the \$1 million range.

Dave Windley - Jefferies & Company - Analyst

Okay, thank you.

Operator

Thank you. We have a follow-up question from Douglas Miehme from RBC Capital. Please go ahead.

Douglas Miehme - RBC Capital Markets - Analyst

Yes, Steve, just getting back to the timing, the charging and the reactor, the heavy water, that sort of thing, that occurs after the hearing?

Steve West - MDS Inc. - CEO

Hi, Doug. Yes, I think that would be the case. I'm not an expert on, or even have true visibility on how the specifics of ACL's completion of the repairs, but my understanding is that they probably wouldn't they wouldn't do that until they got the CNSC sign-off that, we need the protocols around the repairs and we might get some visibility on how ACL will want to evaluate the repairs on a go-forward basis. I'm sure there will be some discussion around the inspection of the wells going forward and sort of the nondestructive testing that takes place.

Douglas Miehme - RBC Capital Markets - Analyst

Okay, and the only reason why I ask, didn't it take a while to remove the rods and that sort of thing when they had to shut the reactor down?

Steve West - MDS Inc. - CEO

Yes, again, I'm not an expert in reactor operations. But I think it was more complex to remove and take out the water and the rods, more complex to do that than it is to put the water back in.

Douglas Miehme - RBC Capital Markets - Analyst

Thinking about the future here a little bit, you will have a reasonable amount of cash after this process is complete. Maybe Peter, what can tell us about what you expect the cash position to be given the incremental cost between now and the end of the year to get everything finalized and then with that cash, Steve, is there an idea at the Company to potentially acquire products that would be complementary to what you're doing on the TheraSphere side?

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Peter Dans - MDS Inc. - SVP, CFO

Just in terms of the cash, again, we haven't given -- we gave our cash guidance out before just to help people bridge through the transactions and the SIB. Where we're at today is the balance of 134 and we highlighted the impact of restructuring as well as the inflows from the deals, again, the \$40 million of restructuring, approximately \$5 million of the income from the deal. So net of \$35 million sort of in the transaction restructuring and deal flow coming off of that. But outside of that we have not really given further specifics. But that's, again, gives you a range in terms of where we're at today sort of approximately 100 when you net those numbers out.

Douglas Miehm - RBC Capital Markets - Analyst

Okay.

Steve West - MDS Inc. - CEO

And your question, Doug, about -- would we acquire something, I think it's a bit premature to sort of talk a lot about that. I want to see how the medical isotope business really does shake out to let the dust settle for a couple of quarters on that and we get some sort of visibility and probably some stability in that marketplace, but it's definitely on the go-forward basis. We were looking at growth through a very disciplined approach, I think to both investment and innovation, and definitely would consider acquisition opportunities. Now, those acquisitions could be products. We remind ourselves that we actually in-license TheraSphere, so we would definitely consider opportunities in all of our core business activities where we think we could create a disciplined growth and definitely a platform is looking good for us right now. So I think we've got a lot of complementary expertise and core competencies that would definitely cause us to evaluate opportunities in that arena, absolutely.

Douglas Miehm - RBC Capital Markets - Analyst

Okay. Thank you.

Operator

Thank you and there are no further questions on the telephone lines at this time, so I'll return the meeting back to Mr. Dans and Mr. West.

Peter Dans - MDS Inc. - SVP, CFO

Thank you, operator, and thank you all for joining us this morning. If you have any additional questions, please do not hesitate to give Ana or myself a call. Thanks.

Operator

Thank you. The conference call has concluded. You may disconnect your telephone lines at that time, and we thank you for your participation.



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