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West Pharmaceutical Services, Inc. (WST)

Q3 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the West Pharmaceutical Services Q3 2016 Earnings Conference Call. At this time, all participants are in a listen only mode. Later, we will conduct a question-and-answer session, and instruction will follow at that time. [Operator Instructions] As a reminder, this call is being recorded.

I would now like to introduce you to your host for today's conference, Mr. Quintin Lai, Head of Investor Relations at West. Sir, you may now begin.

Quintin John Lai

Vice President-Corporate Development, Strategy & Investor Relations, West Pharmaceutical Services, Inc.

Thank you, Donovan. Good morning to everyone, and welcome to West's third quarter 2016 conference call. We issued our financial results this morning and the release has been posted in the investor section on the Company's web site located at www.westPharma.com.

This morning, CEO Eric Green and CFO Bill Federici will review our results, provide an update on our business, and financial outlook for the full year 2016, provide a sales growth outlook for full-year 2017 and discuss long term 2020 financial targets. There is a slide presentation that accompanies today's call and a copy is also available on the Investor section of our web site.

On slide two the Safe Harbor statement. Statements made by management on this call and in the presentation contain forward-looking statements within the meaning of U.S. federal securities law. These statements are based on management's beliefs and assumptions, current expectations, estimates and forecasts. There are many factors that can influence the Company's future results that are beyond the ability of the Company to control or predict.

Because of these known or unknown risk or uncertainties, actual results could differ materially from past results and those expressed or implied in any forward-looking statements. For a nonexclusive list of factors which could cause actual results to differ from our expectations, please refer to today's press release, as well as any further disclosures that Company makes regarding the risks to which it subject in the Company's 10-K, 10-Q and 8-K reports.

In addition, during today's call, management will make reference to non-GAAP financial measures, including sales at constant currency, adjusted operating profit, adjusted operating profit margin and adjusted diluted EPS. Reconciliations and limitations of the non-GAAP financial measures to the most comparable financial results prepared in conformity to GAAP are provided in this morning's release.

Now, I will turn the call over to West's CEO and President, Eric Green. Eric?

Eric Mark Green

President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

Thank you, Quintin and good morning, everyone and thank you for joining us today. As we've said in our press release, we had another solid quarter and expect a good finish to the end of the year. Our end-markets are growing and we expect the momentum from 2016 to continue into 2017. Today, we are introducing our preliminary 2017 organic sales growth guidance. We are also reaffirming the long-term 2020 financial targets that we introduced last year.

2016 is the first full-year of our strategic plan and I'm pleased with our progress. We have realigned the organization to our market-led strategy, expanded manufacturing capacity, launched new high-value products and our customers have received regulatory approval for several products using Crystal Zenith and SmartDose technologies.

Looking at our financial performance, in the third quarter, we generated reported sales of $377 million. That represents a constant currency sales growth of 10%. Importantly, these results were broad-based across all market units and geographies.

Adjusted operating margin was 14.2% and 100 basis points better than the prior year quarter. We are getting margin expansion contribution from a number of sources, including gross margin expansion from a high-value product mix and by leveraging our operating expenses. All of this led to Q3 adjusted diluted EPS of $0.53, which is a 20% increase over the prior year quarter.

Turning the slide four, looking at our sales performance, we had solid contribution from both of our business segments. Sales of our Proprietary Products grew 11.6% organically, driven by double-digit growth in Biologics, high single-digit growth in Generics, and mid-single digit growth in Pharma. Our high-value product portfolio, which represents over 50% of segment sales grew 25% organically.

Just like we saw last quarter, we experienced strong customer demand across the high-value products spectrum, particularly for FluroTec products, Westar, our ready-to-use products, Daikyo components, administration systems, and the increasing adaption of our NovaPure offerings.

Our customers continue to look to West, provide critical components and solutions to contain and deliver their injectable drugs. We are meeting this challenge with innovative high-quality products that are available when needed. We have introduced new high-value products, NovaPure 1ml to 3ml plungers, being the most recent example.

The recent milestone successes in the form of customer approvals of several drugs with our Crystal Zenith containment platform and SmartDose drug delivery platform, validates that we are in the right track. Especially satisfying is that these headline successes are attracting new customers that are conducting early evaluations of both CZ and SmartDose.

Some of our customers prefer to develop their own delivery technologies and outsource the contract manufacturing of their devices. We are supporting these customers through our contract manufacturing group. West's contract manufacturing has tremendous engineering knowhow, and is known for high-quality, high-volume production expertise, making West one of the premier CMOs.

Contract manufacturing products, which represent 21% of overall sales, grew 4.6% organically in the quarter. Our pipeline of new delivery in diagnostic devices is robust. We have started the tooling phase for these projects and this will continue in Q4 as our customers prepared for commercial launch in 2017.

Turning to global operations on slide five. We've generated a gross profit margin of 32.1%, an increase of 70 basis points over the last year. This quarter, we experienced our typical seasonal plant shutdowns for preventive maintenance. We also experienced incremental low margin contract manufacturing tooling sales. Despite these headwinds, the favorable mix of faster growing high-value product help fuel the year-over-year gross margin expansion.

As we have said on this conference calls earlier this year, our global operations team has been working to reduce delivery lead time to our customers. The team has made great stride in shortening lead times across our network, which has resulted in a reduced backlog from peak Q1 levels. The underlying demand for high-value products from all three of our market units remained strong.

As we have shown over the last five-years, in fact, over the past 10 years and as we continue to see today, we are growing the high volume product portfolio in excess of 10% CAGR.

I'm also pleased to announce to David Montecalvo has joined West as Head of Global Operations and Supply Chain. David brings a wealth of expertise in global operations, business integration, and product development. As we continue to make significant progress in achieving the operational excellence objectives outlined in our long-term business strategy, including our margin expansion targets, David is a welcome addition to the West team, and we intend to leverage his experience to continue to build upon the progress our team has made.

I also want to mention the recent hurricane that impacted the Caribbean in the Atlantic coastal region of the U.S. One of the impacted areas was Kingston, North Carolina, where floodwaters devastated homes and the surrounding communities. We have a key manufacturing facility in Kingston. While our plant was not damaged, we did have to shut down operations for a few days as many roads were closed. We are back to full operations and we took actions to ensure continuation of customer supplies. Most importantly, all of our employees are safe.

Turning to slide six, in the outlook for the balance of 2016, we remained on track for a solid full-year of organic sales growth and expect adjusted diluted EPS to grow roughly double the rate of sales. We now expect to be at the upper end of the 7% to 9% full year organic sales growth range we previously announced. We are narrowing our adjusted EPS guidance to a range of $2.17 to $2.22, a year-over-year increase of 19% to 21%, which includes the headwinds from changes in FX. Bill Federici, our CFO, will go into more detail on this during his presentation.

Turning to slide seven. Last year, we introduced our long-term 2020 financial targets. We remain on-track in year one of the plan with strong sales growth and operating margin expansion over 2015. We expect to carry this momentum into 2017, and are introducing initial guidance to be at the upper-end of our long-term target of 6% to 8% organic sales growth. We also reaffirm our 2020 financial targets.

Now, I turn it over to Bill Federici who will provide more color on our financial performance. Bill?

William J. Federici

Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

Thank you, Eric, and good morning everyone. We issued our third quarter results this morning, reporting net income of $37.6 million or $0.50 per diluted share. And to summarize on slide eight, excluding the one-time items from both this year and the prior year's quarter's results, our adjusted earnings per diluted share are $0.53 this quarter, 20% higher than our adjusted third quarter 2015 earnings per diluted share.

Turning to sales, slide nine shows the components of our consolidated sales increase. Excluding translation exchange effects, our consolidated third quarter sales of $376.7 million increased by 10% versus our third quarter 2015 sales. Proprietary Products segment sales increased 11.6% versus the same quarter 2015, excluding translation exchange. Sales price increases accounted for 1 percentage point of the sales increase and the favorable mix of products sold and volume increases contributed the remainder of the increase.

Sales of our high-valued products rose 25% versus the prior-year third quarter. As a percentage of proprietary product segment revenues, high-value product sales grew more than 6 percentage points versus Q3 2015, representing more than half of our proprietary product segment sales. We continue to see strong customer demand for our product offerings that meet our customers' high quality expectations.

Sales of CZ and SmartDose were $8 million in the quarter, $600,000 above the prior year's third quarter. Contract-manufactured product net sales increased by 4.6 percentage points versus the prior year quarter, ex-translation. The majority of the increase in contract-manufactured sales was driven by increased demand for diagnostic and delivery devices.

As provided on slide 10, our consolidated gross profit margin for Q3 2016 was 32.1% versus the 31.4% margin we achieved in the third quarter of 2015. Proprietary product third quarter gross margin of 36.4% was 0.9 of a margin point higher than the 35.5% achieved in the third quarter of 2015. The increase in gross margin is due to modest price increases and a continuing favorable mix of sales offset by higher Japanese yen-denominated raw material costs and increases in labor and overhead costs.

The yen strengthened approximately 16% versus the prior year's third quarter. That adverse yen transactional rate increased raw material price costs and thereby decreased consolidated Q3 gross profit margin by 110 basis points. Contract-manufactured third quarter gross margin declined by 0.8 of the margin point to 16%, primarily due to some low-margin tooling revenues and increases in labor and overhead costs.

As reflected on slide 11, Q3 2016 consolidated SG&A expense increased by $3.7 million versus the prior year quarter due to merit and fringe increases, more head count focused on our new market-led organization, as well as increased pension expense. As a percentage of sales, third quarter 2016 SG&A expense was 15.5% versus 15.8% in the third quarter of 2015.

Slide 12 shows our key cash flow and balance sheet metrics. Our year-to-date operating cash flow of $147.6 million is $3 million above what we generated in the first nine months of 2015. Our capital spending was $123 million for the first nine months of 2016, approximately $36 million more than at this time in 2015. We expect to spend approximately $150 million to $175 million in capital in 2016. Approximately 60% of our planned capital spending is dedicated to new products and expansion initiatives, including approximately $60 million for the construction of our new Waterford facility.

Our balance sheet continues to be strong and we're confident that our business will provide necessary future liquidity. Our cash balance at September 30 was $205.9 million, $69 million less than our December 2015 balance, due primarily to the payment at maturity of our Euro B notes in February 2016.

Debt at September 30 was $231.2 million, $67 million less than at year-end, reflecting the payment at maturity of our Euro B notes. Our net debt to total invested capital ratio at quarter end was 2.2%. Working capital at September 30 totaled $421 million, roughly $62 million higher than at year-end, primarily due to increases in receivables and inventories reflecting our growing business.

Looking ahead, our backlog of completed proprietary product orders stands at $388 million at September 2016, about 2% lower than at September 2015, excluding exchange effects and was about $60 million less than its January 2015 peak.

As expected, our order backlog is decreasing as a result of actions we are taking to reduce order lead times for certain high-value products. Based on our year-to-date 2016 results and our analysis of the orders on-hand, and despite the impact of unfavorable currency effects, we have raised our 2016 full-year sales guidance and tightened our full-year 2016 earnings guidance in this morning's release. That guidance is summarized on slide 13.

Achieving the forecasted sales level revenue would result in full-year sales growth at the upper-end of our prior guidance range of 7% to 9% at constant rates. And adjusted diluted EPS should be in the range of $2.17 to $2.22 per share. We have based our guidance on the exchange rate of $1.10 per euro versus the $1.12 per euro assumption using our prior guidance. The relative strength of the U.S. dollar versus most currencies has adversely impacted earnings throughout 2016. We also recognized the continued adverse effects on raw material purchases of a strengthening yen versus the U.S. dollar and the euro. These currency headwinds had reduced reported Q3 earnings by $0.04, and are expected to adversely impact Q4 results by about $0.03, and are included in our full-year 2016 guidance.

I'd now like to turn the call back over to Eric Green. Eric?

Eric Mark Green

President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

Great, thank you, Bill. In conclusion, strong high-value product sales, underlying market growth, and excellent execution of our market-led strategy had contributed to another solid quarter. And we're confident we will deliver the balance of the year. As we prepare for 2017 and our long-term plans for the Company, we are building on a position of strength, which will allow us to continue to deliver value for our customers and for our shareholders.

Donovan, we are ready to take questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: [Operator Instruction] And our first question is from Tim Evans of Wells Fargo Securities. Your line is now open.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Thank you. Bill, thanks for the color on 2017 and 2020. Just can you help us understand how much of your 2020 margin guidance you feel like is now dependent on uptick of CZ and SmartDose versus other high-value product mix shift?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yeah. Tim, thank you and good morning. The bulk of that increase in margin from where we are today to 2020 is relative to the components businesses, especially driven by high-value products. So, the percentage of that growth relative to CZ and SmartDose is small.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Okay. And then, as you think about the pacing from where we are in 2016 to where we need to be in 2020, should we be pacing that fairly evenly or do you still feel like it's just more back-end loaded?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yes, it is more back-end loaded. We will see good strong growth based on what we talked about, the favorable mix shifts, a little bit of price, and the operational efficiencies and leading programs that we've had in place. But there is some in the back-half of the plan there is some accelerated growth due to all of the proprietary deliveries, including our – not only CZ and SmartDose, but also including the many [marked] products as well.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

And lastly, did you quantify the impact of the Kingston facility brief time out there?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

No, we did not.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Thanks.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

You're welcome, Tim.

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.
A

We're ready for the next question.

Operator: And our next question is from Derek DeBruin of Bank of America. Your line is now open.

Juan Esteban Avendano
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.
Q

This is Juan Avendano on behalf of Derek. How are you guys?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.
A

Good morning, Juan.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.
A

Good morning, Juan.

Juan Esteban Avendano
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.
Q

Good morning. Congrats on a great quarter. And I wanted to follow-up on the adjusted operating margin expansion. And so, at a recent competitor conference you mentioned that on a normalized basis, based on your long-term organic growth guidance of 6% to 8%, you would expect 50 basis points to 70 basis points from the mix shift on to more HVPs, but obviously this is exclusive of the operational improvements. And so, how much of a margin contribution on a normalized basis would you expect from your operational initiatives only?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.
A

Well, that will change each year, right? The 50 basis points to 70 basis points on gross margin is an average. We like to think about it from an operating profit margin basis of about 100 basis points in total. So, if you want to do the math, you can do the math. But operational efficiencies will be somewhere in that 30 basis points to 50 basis points depending on the year.

Juan Esteban Avendano
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.
Q

Okay, great. And another question I had is, just curious, I mean, usually in 3Q you issue a five-year outlook, five years outward and in this case you reaffirmed 2020. Why not give a 2021 guidance this quarter?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.
A

Juan, that's a very good question. We, historically have given a five-year guidance, our targets, that's correct. This year, as we did it last year, we're very focused on strategies that we just launched. We're very pleased about the first year of that performance. And we're keeping the organization focused on delivering on the 2020 targets that we have communicated.

I think at this point that's where we will stay focused on, as things developed and changed overtime, we will continue to update, but we're really focused on the 2020 target at this point.

Juan Esteban Avendano
Analyst, Merrill Lynch, Pierce, Fenner & Smith, Inc.

Q

Okay. Thank you, guys and congrats again.

Operator: And our next question is from Paul Knight of Janney Mont. Your line is now open.

William March
Analyst, Janney Montgomery Scott LLC

Q

This is actually Bill on behalf of Paul. How are you doing?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Good. How are you doing Bill?

William March
Analyst, Janney Montgomery Scott LLC

Q

Doing well. Maybe just talking about the five-year plan Eric, year one focused around realigning the sales organization, and organic growth has grown by about 300 basis points versus last year. What should we think about as the next step of next evolution of the plan?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Bill, that's a good question. We look at our business. We've mentioned before about half our business is around the Biologics and the Generic customer segment. And as you know, we've mentioned that we're growing well in the double-digits with both on the year-to-date in 2016.

The underlying trends in the Biologics is very favorable for West, and our base has been larger around the Biologics. And it's not just the core elastomer and seal business, but it's also the adoption and the interest on our self-injecting systems, which encompasses SmartDose and CZ and SelfDose devices.

So, fundamentally, when you look at – as the business continues to grow with the Biologics and the Generics momentum that we're seeing, it's really being driven by the high-value products portfolio. And so we're very confident. So, our actions for the next few years continue to drive this market-led strategy, drive new innovations from this segments dedicated unique products for those particular segments and continue to build out our operations, so we can stay ahead of the demand curve as customers come in with larger volumes as we proceed forward.

William March
Analyst, Janney Montgomery Scott LLC

Q

And on CZ and SmartDose, can you talk about maybe some type of quantification in terms of uptick in request based on and [Emalogic's] use for cryogenic reason culturing reasons, or just in general uptick following a few regulatory approvals?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Couple of areas that I'd like to share with you. One is, last couple of weeks that we had – or last week we're at a PDA Conference in California, and the interest level of conversations around our self-injection systems, we're talking about the SmartDose, CZ, SelfDose is increasing because there are unique issues that our biologic customers are faced with. They talked about higher viscosity, they want to get away from silicon oil, they have issued especially in stem-cell therapies around cold storage. These are issues that we can help solve with this portfolio.

So we have, as we mentioned in the past, we have double-digit number of development agreements with self-injection systems where we have a number of customer conversations that are a handful at this point that have surfaced since the releases of [indiscernible] . And we're also seeing the increase in customer engagements around the technology assessment, which is very important.

That's a precursor before you get into these agreements. So, we're very encouraged. And the level of engagements we have with most of the top companies developing Biologics across multiple drug delivery modalities is very favorable at this point, Bill.

William March
Analyst, Janney Montgomery Scott LLC

Q

And then I just have one more for Bill. Bill if you could, in terms of the headwinds from the yen, it looks like that doesn't dissipate until about 2Q next year. So, is that something to think about a little bit on gross margins as we look at 2017? And then on the share repurchase, should we expect that to be completed by year-end? Thanks guys, have a good day.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Okay, Bill. So yes, the impact to the yen will continue as we continue to buy materials denominated in yen. Just to remind everyone that 2016 guidance does include that impact for Q4. But you are absolutely right it will impact us at least through the first part of 2017. And on your last point, yes, we fully expect to continue the Board authorize share repurchase program through the end of the year.

Operator: [Operator Instruction] And our next question is from Dave Windley of Jefferies. Your line is now open.

David Howard Windley
Analyst, Jefferies LLC

Q

Good morning, thanks for taking the questions. I apologize, I did have to jump on late, but I guess my first question is, just a curiosity about the long-term forecasting and the kind of the change in framework from rolling out a year versus reaffirming what you rolled out last year. And how you're thinking about that and how we should take your longer term confidence in that outlook?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Dave, good morning and thank you for the question. When you look at the outlook, I know historically, we have provided five years at West. Last year, we launched a pretty significant focus on a new strategic plan, and driving the organization to be more market-led. And with initiatives we put in place, we are seeing very strong traction. I believe it's important for us as an organization to at least stay focused on what we've communicated in regards to our 2020 targets.

And so, as we stand today, we believe, based on the market trends, based on the adoption of our new products, and the strength of our high-value product portfolio, the adoption towards more higher quality has given us an increased confidence that our 2020 targets are – continue to be the goal for all employees around West. So that's where we're focused on. When things do change overtime in the next few years we will continue to update as we talked about, but, Dave, that's where we're focused on right now, the 2020.

David Howard Windley
Analyst, Jefferies LLC

Q

Got you. And so then, within that, it seems like as we've compared performance against some of the plans that go back further in history, the company's performance has tended to run below the targets. I think largely because of the timing around some of the harder to predict elements, like CZ and SmartDose.

Is it right to think that perhaps, kind of what I think of as the steady core business, the components part of the business, maybe the contract manufacturing part of the business, kind of runs you toward the low-end of the overall range? And then CZ and SmartDose, those are more inflection driven and would drive you up into or through that range; one, is that the right way to – is that the way you guys think about it; and then secondly, could you elaborate on how you see that inflection progressing over the next four years?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Okay, Dave, thanks for the question. I think when you take a look at our targets and their comfort levels of – if you've historically – you are right, there has been some adjustments. But I would say majority of that has been around FX. And there is more – the was question about adoption of CZ and SmartDose, which is a really in the hands of our customers and moving to commercial state. But saying that, if we look at where we are today and we are seeing the increased focus around the generic and the Biologics with this new dedicated market-led focus of the four segments, we believe the penetration – there's a little more acceleration than we anticipated. So, we do believe that the way that was structured, they're focused, is driving the high-value product portfolio faster than we've seen in the past, and frankly, that's a bigger base today. So, that's a very strong positive. I think, Bill do you want to comment on the cadence.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

So, Dave, it's absolutely the way that you're thinking about it is correct. We expect the near-term of that time period between now and the end of 2020 to be driven a lot more by the high-value products. And its continued growth driven as Eric said by Biologics and Generics. There is an inflection point in the curve. Eric also mentioned that we do not control over the timing over that. That's customers controlling the timing. But we are encouraged by the amount of activity that we have in both CZ and SmartDose across the entire portfolio.

We have this idea about the primary drug container being integrated into a delivery system to create an entire unique delivery system for the customer is something that resonates with our customers and we believe that will continue to drive strong growth going forward. But in terms of the exact timing of when that inflection point is, we do not control that. And just a reminder, in the 2020 numbers, we don't have a huge amount of CZ and SmartDose in there.

David Howard Windley
Analyst, Jefferies LLC

Q

Bill, do you quantify that, or is that something that's [footnoted]?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

I say, as we said, We've got $100 million base approximately of proprietary devices today mostly with the administration systems, the reconstitution devices are the biggest part of that today. And we expect that to grow very solid as we go through the time period.

We have not put official number on the CZ and SmartDose in 2020, but the $200 million band – $2.2 billion to $2.4 billion does anticipate that a lot of that band is due to CZ and SmartDose. So, the uptake of CZ and SmartDose roughly equates to that band.

David Howard Windley
Analyst, Jefferies LLC

Q

Right. Okay, thank you. I'll drop out, somebody else ask questions, thanks.

Operator: And our next question is from Larry Solow with CJS Securities. Your line is now open.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

Hi, good morning, guys. Just a quick commentary on the 2020 versus the five-year target, I actually think, if I may, that probably just as important or is that more important that you actually have some increased confidence in your 2020 versus putting out of 2021. Because I know that originally the five-year targets were put in play, 2012 or 2013, just a sort of give people an idea about how much upfront spending it will take to get to these numbers.

So just a little commentary from me and just on the high value products – actually on the proprietary products and the backlog sort of now coming down significantly. Do you think that you've gotten rid of most of the access lead time, if you will? And obviously, you've done a great job on the manufacturing and throughput side, and we sort of see this backlog maybe stabilize for a while then continue to grow upwards?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

First of all, your first comment, I want to thank you for that. I appreciate that comment. Secondly, is in regards to backlog, you're right. We've worked very hard over the last 12 months to really debottleneck some of our operations, and particularly up in Jersey Shore in Pennsylvania and the team did a great job.

And I think we've normalized and stabilized our lead times to customers. There is – when you look at the benefit of that is now we have the ability, customers that want to convert from standard packaging to high-value products will see the lead times are more acceptable.

So we think the conversations with the customer to be more favorable. They will continue to see the demand continue to grow nicely with the high-value products. But I also believe that as we look at the demand that's coming in and the conversations we're having specifically on the Biologics and the Generics remains robust.

I just want to remind you though that in the Generics that when they come in, they convert from standard packaging to whether it's Westar RS or Westar RU, you're talking about millions of components. And because there were very short window of opportunity to get into the market with the Generics, we have to respond quickly. So, we're positioned really well now. So, we handle those customers with requests, but it does become little lumpy from quarter-over-quarter.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

And just more color, you mentioned some significant approvals on the CZ side. Is that most of the stuff we have already heard about, or were there any incrementals over the last quarter on the approval side on the launch?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

It's consistent to what we have been communicating over the last – more recently and yes, that's correct.

Operator: And our next question is from Arnie Ursaner, a Private Investor. Your line is now open.

Q

First, with – on the contract manufacturing side, do you highlighted that you've got quite a bit of expanded tooling, which has impacted margins. But perhaps you want to also focus on the fact that tooling is usually a very good lead indicator of future opportunities for you?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Yes, good morning, Arnie . That's absolutely correct. In contract manufacturing as you know, we work side-by-side with customers, with particular devices, and when we are investing with our customer in these new facilities, new equipments to manufacture high volumes through our plant. It does take a few quarters to get through.

And those revenues are challenging in regards to the margins. During the tooling phase that just scale up and get into commercial phase, it goes back to what we've typically seen in commercial and the contract manufacturing business unit. So that is correct, Arnie.

Q

So you should see a pretty nice improvement in the margin next year, as it just from tooling to outright manufacturing?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

We'll see an incremental improvement in contract manufacturing into next year. And then I want remind you that about third of that business is consumer goods, which is somewhat soft in that segment and while the Pharma and med device diagnostic space is pretty robust. So, we see that continued trend and that's where our team is focused at this point.

Q

At this time of the year, typically, you have a number of your more sizable multi-year contracts that come up for renewal. Could you comment on that? And given all the volatility in oil and raw materials, how you expect that to impact your pricing going forward?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Right now, just quickly Arnie, on the agreements. Yes, you're right, we're growing throughout the year. We continuously have conversations with the customers. There's been really no change in cadence and how we have those conversations. And so we don't expect any variation up or down based on what we're seeing with our agreements. Bill, do you want to comment real quick on the raw materials?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Raw material prices continued to behave – you know that our main component of our rubber formulations is a derivative of oil. And oil prices have ticked up a little bit during the year, but not tremendously. So, we don't see any measure surprise. And we don't believe that there will be any major change in the price of oil into the foreseeable future. The Japanese yen purchases raw materials are an issue and will continue to be so into 2017.

Q

Two more real quick ones, if I can. You have been asked several times about the five- year shifting to four-year reiteration. My recollection was your compensation on the long-term incentive plan used to be driven by the five-year plan. Did that change in the last year or so?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

No, Arnie, that's still consistent. And we're looking at three-year CAGR on revenue and ROSC targets about three year out for our long-term incentive plan, that's correct.

Q

And my final question, I know, you're constricted by a lot of agreements with what you can say about actual individual drugs that are in development or where your products are embedded in the system. But maybe in total, you could speak about the number of drugs that have been approved using either SmartDose or CZ, or alternatively the numbers that are in Phase 3 testing, because that will drive your growth for 2017, 2018 and well beyond. Maybe you could help us find the total on those?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Yes, Arnie, you're right. In terms of what has been approved and what we've communicated, there are three modalities of CZ that's been approved now in the commercial markets. And obviously, in the last quarter we have the announcement apparently with Amgen on the SmartDose.

In regards to the pipeline, we can't give granularity. We do not give granularity on what's in the pipeline. But at this point we do have, as I mentioned earlier, we have double-digits number of development agreements in regards to our self-injection systems. And in that we'll continue to see interest in the CZ platform.

Q

And your facility in Arizona will be able to handle the volume if you get the demand, are you finished with that?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

That's correct. The facility has been approved, has been audited, and we are actually manufacturing SmartDose devices out of Arizona today. We are able to handle demand requirements over the next couple of years.

Q

Thank you very much for taking my questions.

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Thank you, Arnie.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Thank you, Arnie.

Operator: And we have a follow-up question from Larry Solow with CJS Securities. Your line is now open.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

Just real quickly on obviously the whole high-value product portfolios continues to expand. Just any particular color just on some of your two newer, more comprehensive offerings, particularly NovaPure, which sort of helps the client throughout the process. And with the acceleration approvals from some of these smaller companies that may need this more, any thoughts on that and how trends are going there? Thanks.

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

So, Larry, the trend on NovaPure, the whole portfolio is very positive. In fact, the thesis around that was around quality by design and we're seeing that, the adoption. You're right and around [emerging] biotechs is they are very interested because of the documentation trail and the capabilities to provide the highest grade of product in the elastomer space.

Last one to note – I do need to mention that, we're also seeing the interest in the uptick with our large biotech customers. So that's not just only emerging biotech play, but it's also been adopted by our larger customers. It's early stages, and as you are seeing with the high-value product portfolio. But that's the strength of the portfolio and the focus around innovation and technology. They are looking at continuously expanding new innovative products into these portfolios of high-value products and continues to react into our customers' needs.

Operator: And our next question is from Dana Walker with Kalmar Investments. Your line is now open.

Dana Ford Walker
Analyst, Kalmar Investments, Inc.

Q

Thank you, good morning.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Good morning, Dana.

Dana Ford Walker
Analyst, Kalmar Investments, Inc.

Q

Could you gentlemen talk about, aside from CZ, what you buy that is yen denominated?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Yes. So, we have a partnership with Daikyo. And we represent we have – and this is a 40 plus year old relationship, very strong relationship. We represent some of their components outside of Japan, in the Japanese market.

So, when we work with customers, we obviously have the West portfolio, but the Daikyo complements quite nicely and we are working with our customers and delivering the Daikyo components to our customers. So, you're right, outside of the CZ arena.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

And we also have – we buy rubber components from Daikyo, the floor tech stock, et cetera. So, there is both of raw material component and representing Daikyo from a sales perspective.

Dana Ford Walker
Analyst, Kalmar Investments, Inc.

Q

Do you have any ability with either – I presume what we need to be customer arrangement to where you can true-up the economics for you or do you just have to take it as is?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

We don't talk about the individual customer agreements, Dana. But what we try to do in that regard is we will try to hedge some of our exposure through the normal hedging activities that we have for transactional exposures, like we do on the euro and some of the other things we have.

Dana Ford Walker
Analyst, Kalmar Investments, Inc.

Q

But hedging would more smooth reality rather than try to comport reality to an economic margin based on a change in procurement price?

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

And as you know, currencies fluctuate Dana, a few years ago, we're benefiting from the yen. Now what happen in the third quarter, we took it really on the chin and looks like the fourth quarter will be the same. As I said $0.03 impact is expected in the fourth quarter. But, no, we understand your comments and we take it into our guidance, and that's about what we can do.

Dana Ford Walker
Analyst, Kalmar Investments, Inc.

Q

Ok. How about an update on some of the megatrends that have been helping injectable products and how they're touching you like with vaccines and diabetes care as for instance.

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Yeah. Dana, one of the big drivers is around the Biologics space. And if you look at, first of all, hearing from our customers but also available data, such as offered by the IMS, we really focus on the volume component, not the end sales of the drug in the marketplace. And what we're seeing is the volume increase in biologic drugs is around the high single-digits. And the outlook still remains very positive.

So, again, this is all about the uptick on higher quality materials that are used to contain the Biologics and for administer of injectable medicine. I think in the Generic space, we're seeing a positive trend to more branded drugs that would be going into Generic space. And because of the speed of the markets and that trend and also there's higher degree of quality requirements from the FDA and other regulatory bodies, that we play very nicely with our high-value product portfolio. So, the megatrends really haven't changed from last year when we talked, it's playing out as we anticipated.

Dana Ford Walker
Analyst, Kalmar Investments, Inc.

Q

Yes. Maladies though like diabetes and the increased use of vaccines, though, were subtext drivers to West's demand profile. Would you say that that continues to be so or are they moderating in their rate of growth?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Dana, I think you're right. The diabetes market is always looking at new innovations. First of all, we are currently working with the diabetes market major players from two angles. One is, in our core business with the high-value products, from the elastomers and seals, but also with the delivery devices that are owned by the diabetes companies.

We are manufactured with a contract manufacturing business. So we are positioned well in that area. And as new innovations present themselves, we're also very well-positioned from both fronts, one, contract manufacturing but also with the primary container of the drugs.

Dana Ford Walker
Analyst, Kalmar Investments, Inc.

Q

Final question relates to Ireland. One presumes that when you open in Ireland, that your currency matching in having euro-based costs to service euro-based revenue will rise, so that your sensitivity to changes in the euro will become more translational rather than transactional, and they will be less translational than they were.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Not sure that I agree 100%. Dana, I understand what you're saying. We will increase the amount of activity in Ireland. We have a fair amount of activity today. That activity will be naturally-hedged, as you said. A lot of the costs and the revenues will be in euros. There will be a translation impact as we bring those local currencies back into U.S. dollars for reporting purposes.

Dana Ford Walker
Analyst, Kalmar Investments, Inc.

Q

Okay. I wanted to be corrected. It feels good.

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

Thanks, Dana.

Quintin John Lai
Vice President-Corporate Development, Strategy & Investor Relations, West Pharmaceutical Services, Inc.

A

Operator, we have time for one last question.

Operator: Our final question is from Dave Windley with Jefferies. Your line is open.

David Howard Windley
Analyst, Jefferies LLC

Q

Hi, thanks for taking my follow-up. I wanted to follow up on some of the growth trends in your release, and I'm sure you talked about it in prepared remarks. But organic proprietary product growth in the 11.5% range and then you detail out by end customer segment. Two of those three are below 11.5%. So I'm inferring that your Biologics market growth, the double-digit is a humble way to describe that growth and it must be at least high-teens. Is that fair, first of all?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc.

A

I think, Dave, when you take a look at year-to-date, let's start with the year-to-date number. Both Biologics and Generics are in the mid-to-high teens. And so that has been driving the year-to-date performance. Quarter-to-quarter, it does fluctuate a little more in the generic space. But we do see some fluctuations. I think when you look at Q3, in specific, Biologics was very strong and Generics was a high single. So, you can see the math, how that works.

David Howard Windley
Analyst, Jefferies LLC

Q

Got it. So, appreciate the smoothing, so kind of think of those as mid-to-high teens year-to-date, and that gives you a little bit better sense of trend. And then on – two part here, two part thought process. High-value product offering is growing 25% in the quarter, which is really strong. Certainly congratulations on that, and even a little acceleration from 2Q, I believe.

And I guess, I was wondering, how we should think about the incremental margin benefit from that. It didn't look to be quite as much as maybe you've seen in the past, or as much as I might have calculated. Is that a function of maybe some of the currency headwinds that are mitigating that, or what might be other factors that I should take into account?

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc. A

Dave, sort of the couple components, one is just to reiterate. We did have our typical seasonal shutdown, but we did it last year, so it's not going to be much variation, that's very good point there and you talked about absorption and utilization. But when you look at excluding the impact of the FX transaction exposure, particularly when you look at the yen, our consolidated gross margin expansion would have been 180 basis points versus the 70 basis points that we reported. So this is a prime example when you look at the leverage that we can achieve when we have strong HPP adoption and sales growth.

David Howard Windley
Analyst, Jefferies LLC Q

Right. Okay, that helps. Thank you very much.

Eric Mark Green
President, Chief Executive Officer & Director, West Pharmaceutical Services, Inc. A

Thank you, Dave.

William J. Federici
Chief Financial Officer & Senior Vice President, West Pharmaceutical Services, Inc. A

Thank you, Dave.

Operator: And I'm showing no further questions at this time. I'd like to turn the conference over Quintin Lai for closing remarks.

Quintin John Lai
Vice President-Corporate Development, Strategy & Investor Relations, West Pharmaceutical Services, Inc.

Thank you, everyone for participating on the call. An online broadcast, archive of the broadcast, will be available on our web site here later today. It's also available to dial in through Thursday, November 3 and the call information is in the press release. Thank you and have a nice day.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.