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West Pharmaceutical Services, Inc. (WST)

J.P. Morgan Healthcare Conference - Q&A

CORPORATE PARTICIPANTS

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Bernard J. Birkett
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MANAGEMENT DISCUSSION SECTION

Tycho W. Peterson
Analyst, JPMorgan Securities LLC

So we have here in the breakout, we've got Eric Green as Chief Executive Officer of West; Bernie Birkett, Chief Financial Officer; Karen Flynn, Chief Commercial Officer.

So, [indiscernible] (00:00:14) questions.

QUESTION AND ANSWER SECTION

Q

I'm intrigued by the integrated solution business. And so, I imagine you've been doing some form of that...

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

A

Right.

Q

...over the long-term, but I guess you're just [indiscernible] (00:00:29) getting better and more embedded [indiscernible] (00:00:34) what's different [indiscernible] (00:00:36) from that?

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

A

Yeah.

Q

[indiscernible] (00:00:39)?

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

A

Yeah. I think I'll start and then I'm going to ask my colleague, Karen to give greater detail, I think, one thing we've...

Tycho W. Peterson
Analyst, JPMorgan Securities LLC

Q

Can you repeat the question [indiscernible] (00:00:49)?

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

A

Okay. So, it's really around the integrated solutions and thinking about how does that evolve and as we think how will that interact with either future products or future services as we go forward that West can offer. And I think when we started thinking about all the capabilities we have internally already that we've been doing for our customers at a request level and we've been finding through the insights of our different market leaders whether it's biologics or the pharma segment that our customers are looking for more of a comprehensive portfolio of solutions, basically coming back [indiscernible] (00:01:27) the results of the findings of the tests that we've conducted.

So we have the capabilities internally that we've used for a number of years and we've built it up more recently. And I think we're just pulling it together as more comprehensive business model going forward. But Karen, [ph] do you want to give a little (00:01:43) more detail?

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yeah. I think you're right. West has a number of capabilities and we've been interacting more discreetly with customers as they've been asking us for product or services. And what we've come to realize is that there's a real need to partner with customers as they are in various phases of development and come forward to them with more of a comprehensive solution that will enable them to move from, say, Phase 1 to Phase 2 or Phase 2 to Phase 3 more seamlessly.

And so, what we're saying is we are the experts in packaging. We know how the primary package should interface with a delivery system. We know that there's complexity around combination products and the regulatory filings associated with that. Here's a portfolio of capabilities that West has that will help you to fill out that regulatory pathway and accelerate your development. And it certainly helps them accelerate, take some of the risk out, but it also helps West, because we're engaging upstream in the development and in doing so, you know pointing them to our solutions.

Q

[indiscernible] (00:02:55)

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

A

No. [ph] Don't read into that please (00:03:02). The historical guidance with long-term construct that we've always given we, I think we commented on our last call, in Q3 call, that we – during one of the Q&A sessions that we see

no change. But what we have done, there was a change in the sense that we moved it from a Q3 call to a Q4 call of giving confirmation of long-term, but also for 2018 guidance.

I can say though where we are with our thinking in regards to long-term. We still believe in the 6% to 8% organic growth for the business. And our confidence with the 100 basis point operating margin expansion continues to increase in particularly with two things. One is that we continue adoption of high-value products [indiscernible] (00:03:51) drives some of that mix shift in that margin expansion. But more importantly and we demonstrated in the last couple of quarters, Q2 and Q3 to be specific that in our proprietary business the globalization of the operations is driving performance. We had 150 basis points and we had 120 basis points, respectively of margin improvement in proprietary. So we don't see a change in that long-term construct. We're also very very pleased with what we've seen over the last couple of years and we believe will continue to accelerate as a free cash flow. You can see influx at this point of time, so we're very – so, long-term construct is still what we're focused on. Yes, sir.

Q

[indiscernible] (00:04:40) capital allocation over the next four or five years as you start to generate more [indiscernible] (00:04:48)?

Bernard J. Birkett
Senior Vice President, Chief Financial Officer & Treasurer, West Pharmaceutical Services, Inc.

A

Yeah. You can see there's been a change in the CapEx spend that we have forecast for 2018 compared to what we've seen for the last number of years. The predominant driver there is that we don't have to invest in obviously buildings and footprints as we already – we put enough infrastructure in place. That's going to help drive free cash flow plus obviously revenue growth and margin improvement.

On the capital deployment side, we have a dividend that's been in place for the last 25 years. We've done some level of share buyback which is really to keep our share count neutral. And what we're also now looking at doing is looking at on the M&A side where we need to invest from a strategic point of view that really complement the strategic initiatives that we have plus broaden and support the customer base that we already have in place. But we're doing that with a very disciplined approach. So obviously, we're looking for revenue growth and EPS accretion on a cash basis, but also looking at ROIC over specific periods of time to make sure that we're getting the right returns. So, we're continuously looking at options that are out there and we just want to make sure that they fit within our business. So we don't want to do acquisitions just for the sake of doing them. They have to complement the long-term growth strategy that we already have in place. Yes, sir.

Q

[indiscernible] (00:06:24-00:06:37)

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

A

Yeah. I'll be clear to the – our entry into that is really around our contract manufacturing when we are manufacturing device for our clients. We're also looking for us to handle the primary containment of a drug that requires cold chain storage, so that we put that asset in place, so we can take it to the next step where we're actually combining the pre-filled drug into the device itself and then getting it into the channel. That's a step that

we're able to take out of our customers or [indiscernible] (00:07:08) other partners hands and put it within our capability. You can imagine as we build these capabilities being closer and closer to the channel, this is excellent example of actually obtaining that.

That was the main thrust behind that. It's been a [indiscernible] (00:07:23). Our customers have been asking us to get involved in this area. We have expertise of handling drug compound, for example, when we go back to integrated solutions, we actually have our customers' prized possessions on site that we're actually using to test. So, therefore we do have these competencies that we're starting to branch out into our manufacturing sites. But at this point, we're not going to elaborate any further what that means and how much further [indiscernible] (00:07:50) go down the road with cold chain storage [indiscernible] (00:07:52).

Yeah. Please.

Q

[indiscernible] (00:07:56)?

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

A

Safety stocking?

Q

Yeah.

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

A

No. I think what we do with our device manufacturing business. We've really did not inventory that ourselves. One of the business models we've always had in support of our customers is once we manufacture, we align, we get into the channel. So, we don't see ourselves becoming a holder of finished goods in the device side of contract manufacturing.

Q

[indiscernible] (00:08:25).

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

A

Absolutely. You want to cover that?

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Sure. Yeah. So, the biologics portion of our business as you know is roughly 25%, little bit less than 25% of the business. And given that it's a $350 million business quarter-by-quarter, you see some fluctuations in the revenue and it particularly is related to customers and as they manage inventories in anticipation of drug launches and

then how those launches manifest themselves in terms of success in the marketplace. Certain customers will buy forward inventories in preparation for launches and then they'll work those inventories down. And that's what we saw a lot happening in 2018 actually.

We are getting closer with customers and driving conversations around trying to understand more what their plans are with regard to inventory management so they can do a better job of communicating that externally as well.

And also putting more emphasis into analytics around forecasting and understanding the broader market dynamics so that we can do a better job of understanding how that will impact the demand in our biologic space. So we do expect that there will continue to be some volatility in biologic just because of the nature of those products and the launches as I mentioned. But we really want to do a better job of engaging with our customers and engaging with you all so that you can have better visibility to what those spikes and valleys will be.

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

A

And to add on that [indiscernible] (00:10:10) when you think about the pipeline where we participate and you think about the commercialization when the drugs are approved we have pretty good visibility. Are we on, are we not on that particular molecule. In the biologic space, West and our partner, Daikyo, continues to have the majority of participation on all the biologics. We think biologics versus small molecule versus generics, branded small molecule and generics is the highest of those buckets. So, we're very confident. We have good line of sight. I think as the business grows and gets more in the volume and less volatility, we'll be much more comfortable on the predictability. Yes, sir,

Q

[indiscernible] (00:10:51)?

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yes. The regulatory aspects of qualifying primary packaging components with biologics, it's costly. So, what we find are that customers tend not to dual source, some do but most tend not to, where our customers want to evaluate multiple product offerings. West is fortunate, of course, we have our own portfolio of products and we have our partner Daikyo's portfolio as well. So we can provide offerings so that they can evaluate what's the best fit for their molecule as they are advancing through the clinical phases.

But, what we find is that, it's very rare that a customer will dual source or bring two different packaging formats to the market, say for a vial containment. It's just too costly and too cumbersome and complex for them to manage multiple supply chains. And so, this is why we're spending a lot of time in engaging with emerging bio companies as well as the more established biologic companies and wanting to work with them earlier in their clinical development, so that they're understanding West portfolio West and Daikyo portfolio of products and finding the right fit for that – over that primary containment.

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

A

It's a great example of why Westar Select was created, where our customers are able to rely on more than one manufacturing site for the same process and therefore the risk mitigation is being addressed. And so, you think about going in the future, if we fast forward as long as we continue to drive a continuous network globally and not

have our customers [ph] rely and (00:12:45) pointing to a particular site, which has historically has happened, but versus a process. And our process is very unique, cannot be matched by others and vice versa. So [indiscernible] (00:12:55) business, but yet we have that flexibility and that assurance of supply for our customers to alleviate the concerns.

Q

[indiscernible] (00:13:05).

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

A

Right. There is another one for you Karen.

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yeah. We're really excited about AccelTRA. It's a great example, I think Eric talked about at the podium around us developing an even greater understanding of what that particular segment of our customers' need and introducing that product. And we're continuing to invest. It's not just a product, but it's a family of products. And so, we're going to be rolling out more and more items within the AccelTRA family in the next year and even beyond that.

We've sampled hundreds of customers in the past year and a half and we're going to continue to work with them in their conversions for both West products that they're currently buying and converting to AccelTRA. As well as taking share from maximizing our penetration with those customers beyond where we're currently selling to them in the products that they buy from West. So we're really excited. It does take some time. They've got to go through the qualification and do the work that's necessary to prove compatibility and to make that transition, because it is a new elastomer formulation. So it does require some testing and regulatory approvals.

Q

[indiscernible] (00:14:28).

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yeah. Yeah.

Q

[indiscernible] (00:14:31).

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Well, yeah, just to clarify. So historically West has had hundreds of different rubber formulations. So the chemical nature of that stopper, there's many many, many different offerings there. AccelTRA is one rubber formulation so the chemical composition of the elastomer remains the same. When I say many products, what I mean is many different shapes. So if you think about a 13 millimeter [indiscernible] (00:15:02) vial versus a 20 millimeter, a

plunger, cartridge, the drug formats can be quite different. So it does require us to have a portfolio of different offerings in order for us to satisfy the containment needs of our customers.

Q

[indiscernible] (00:15:21-00:15:35).

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

A

Yeah. I think – I'll let you talk about the margin. But if you think about One West and where we're going with that journey, I think there is a lot of opportunities, because it's the first time we've looked at all sites. We announced a restructuring early in 2019. We believe the site closures that we're targeting at this point in time will be totally completed by the end of 2019 and it's about a $20 million benefit in 2020 and that's ongoing benefit. That's just one example, but the other levers that we're polling within the global operation, globalizing through a One West, you started thinking about harmonizing our operations, level loading and we believe that will give us continued margin expansion for a number of years to come.

[indiscernible] (00:16:19) not that we operate it incorrectly, it's just [indiscernible] (00:16:22) does take time. We have to work with some customers to harmonize and relocate some of their production products. But outside of that, I think this is going to be a long-term journey that we have tremendous opportunities to capture more value. Do you want to talk about the margin?

Bernard J. Birkett
Senior Vice President, Chief Financial Officer & Treasurer, West Pharmaceutical Services, Inc.

A

Yeah. So just in general on the margin, we've got a roadmap which is outlined for a number of years to help support the 100 basis point improvement in margin, year-over-year and we're really focusing on – a lot of it is around standardization, globalization across all of the sites, lean initiatives being run across the 28 sites, standardized KPIs, and bringing that level of professionalism to the operational structure. There's a level of restructuring that's taking place from moving from 28 sites to 25 sites [indiscernible] (00:17:14) complete 2019, 2020.

And [indiscernible] (00:17:15) also see investing in automation. We have a number of automated processes that were validated over the last, probably the last 12 to 18 months. They're being rolled out in our Kinston facility. Once they rolled out there, there will be [indiscernible] (00:17:31) a number of other facilities over the next number of years, so it's an ongoing process. So, we're starting to see the benefits flow through. As Eric mentioned earlier, we've seen it in Q2. We've seen it in Q3 on the proprietary side. There's a long runway for us in this. And we have mapped it out very, very clearly as to when we will start to see various improvements coming in each of our facilities and processes.

So that's on that side. And then, I think – [indiscernible] (00:18:04).

Q

[indiscernible] (00:18:05).

Bernard J. Birkett
Senior Vice President, Chief Financial Officer & Treasurer, West Pharmaceutical Services, Inc.

A

On the contract manufacturing piece. Yes. So, what we saw was that the margins in contract manufacturing, particularly in the first half of the year, we saw some downward pressure on those as we began to scale with the demands of our customers to scale pretty quickly in certain areas. And what we have is we had to meet the demands that were there. It costs us to do that. We had to hire people pretty quickly. There was a learning curve [indiscernible] (00:18:33) bringing those people on. So it affected the level of productivity from the new hires, but also the existing hires [indiscernible] (00:18:41) because they had to go and train the new people.

So, we had that pressure. And what we saw in Q3 and we had guided [indiscernible] (00:18:47) Q2 that we would see some improvement in margin for contract. We saw that take place in Q3. We've talked about it improving for – in the back half of 2018 and into 2019 to get back to the levels of margin that we had seen in 2017 and then it did normalize after that. So, we know the improvement is coming. We've seen [indiscernible] (00:19:07). We expect it to continue over the next number of quarters.

Q

[indiscernible] (00:19:16-00:19:31)

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

A

Right.

Q

But there is this complex regulatory pathway [indiscernible] (00:19:35). So how do you think about this piece of the business evolving and I think that West [indiscernible] (00:19:41).

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

A

All right.

Q

Can you comment on that?

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

A

Right. That's exactly the point is that how can you simplify the journey with our customers? We've been through it once [indiscernible] (00:19:53) to the goal line with having a combination device approved by the FDA and now it's being launched in different markets. And our customers are coming to us and trying to standardize their molecules on the platform. So it could have various volumes that go through, but we're looking at different generations that can support them, but it's still a combination device. And when you have a combination device, you do still need to go through the process of validations and stability tests.

So I think this is – but this is where West brings to the table that expertise and that capability. But I can assure you the interest level after the approval was gained increased. This is a long play though. It does take several years to go through clinical trials, scalability, but once that gets completed, once you're on, you are on for a very long period of time.

So, when you look out in the horizon on the short-term, it's going to continue to grow, it's going to grow with a certain percentages, it could be high, mid-sized, but it gets meaningful a number of years out when a number of drugs are on this product in the marketplace. And we're currently dealing with a number of that at this point in time.

Q

[indiscernible] (00:21:09-00:21:18).

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

A

Yeah. Absolutely. So, our market share with majority of the customers is quite high. So there is this significant swing from 100% to 0%. And so, if you look [indiscernible] (00:21:31) our customers and our shares [indiscernible] (00:21:34). If there is a consolidation that does occur, a lot of times as you know [indiscernible] (00:21:40) goes after the R&D, first, right. And we're involved with R&D, but our customers, you're talking about buying 1,000 or 2,000 components which is really nothing.

And [indiscernible] (00:21:52) do the research. The real key point is, when they commercialize and if one firm acquires another firm. Typically in most cases, they do not change the filings of those drug compounds. So, for us it doesn't seem as much of a change. It may help us when we started thinking about devices or may help us when we started thinking about bringing contract manufacturing, the proprietary together for that client, because they haven't been accustomed to as much as maybe the one that [indiscernible] (00:22:20) acquired them. But the changing landscape of our customers does not really change end result of West and the drug molecules that we're on.

Q

[indiscernible] (00:22:36-00:22:47)

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

A

Yeah.

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

I think it's early to say. I mean, we'll update – continue to monitor that and work with our customers to understand if there's going to be any impact that they're expecting. But so far it's just a matter of days and weeks, right. So we're hopeful that it's not going to have a meaningful impact.

Q

[indiscernible] (00:23:04-00:23:19).

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yeah. In the vast majority of cases, right, customers are building inventories in advance of approval. And particularly for the types of products that West provides, they want to have these inventories on hand so that they're ready as quickly as they possibly can be with meeting the demands of the market.

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

A

So, the example, the biologics in 2018 where the launch was a little bit delayed, that's a great example in how it takes several quarters to catch up. We're still on the drug molecule. There's no change [indiscernible] (00:23:56) of the business, just has been a delay because of the launch and we do see that at times.

Q

[indiscernible] (00:24:04-00:24:39).

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

A

[ph] You want to cover that (00:24:38)?

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yeah. I think that a couple of years ago, if you're familiar with our business, you saw that our backlog had grown and that was really attributed to some capacity constraints we had and impacted us particularly with our generic customers [indiscernible] (00:24:52) high volume, unit volume, customers for West and we were constrained in some of our washing capability. And what that led to was customers placing orders farther and farther out.

As we brought more capacity online [indiscernible] (00:25:09) in our Kinston facility, we were able to reduce those lead times, increased the capacity available for washing. And as a result, we saw the backlog come back to more of a normalized pattern. And I think that we feel really good, comfortable with both generics and the pharma sector now having engaged with customers, led them through this journey with us to improve our lead times.

We're not done yet. I think there's still more opportunity for us as we're utilizing the footprint that we have and taking advantage of the operational excellence initiatives that we've had, to work with customers to take even more inventory out of the system. But, the opportunities certainly still remains in the Biologic segment. And that's where as I mentioned earlier, that we are focusing now to have more of a dialogue with those customers in preparation for their launches, trying to understand what kind of inventory position are they building, do they need to build as much inventory, how can we make them feel comfortable, what are their requirements and then building that into our plans as we manage that segment of the business.

Q

You talked about building out analytics in addition to just talking [indiscernible] (00:26:24) Is there anything you can tell us about sort of the data services you're looking at? How you can transform that data [indiscernible] (00:26:34)?

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yeah. Well, there are a number of data sources, the traditional data sources that you would see out there in terms of looking at the drugs that are going to be launched and using some of the analytics that are available in terms of the modeling there. But also, it's looking at our historical patterns and what has happened with regard to launch preparedness and how we've seen some of those spike. Can we use that to model, if we see our own funnel of opportunities as the approvals are anticipated and coming in the next 12 months, what should we expect in terms of inventory build for those particular products and then how will that bled. So, it really is triangulating from different sources, our own data and then industry data as well.

Q

[indiscernible] (00:27:26-00:27:33).

Karen A. Flynn
Chief Commercial Officer & Senior Vice President, West Pharmaceutical Services, Inc.

A

Yeah. So, our experience in the generic side when there's an issue with the plant or a particular location or even a line within [indiscernible] (00:27:42), usually it does have an impact on West. But what we usually see is that the generic will reside with some other manufacturer, either within the same company at different location or a different company. And we usually see that pop up [indiscernible] (00:27:59) time to be one or two quarters later. But we usually see that come back up. And West is brought into that conversation. That usually require us to move quickly because our customer wants to get the drug compound on the market fast so there's no drug shortage in the marketplace. But if there's molecules that were produced at these sites that you're referring to we will probably see them – we will see them pop up somewhere else in our whole customer spectrum.

Q

[indiscernible] (00:28:30)

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

A

There could be, it depends, because there might be two or three alternatives already in the marketplace that we're working with. In some cases, there aren't. And so, it does depend on the molecule and just to put it in context so that we level set, when we talked about a particular drug compound from a component's perspective, our revenue on that compound could be $3 million, $4 million to about $12 million or $15 million a year. So it's a $1 billion drug, it might be $15 million of components. So the reason I bring that up is that, the impact on us might be visible, right, but it's not going to be material unless it's multiple sites and multiple drugs. So that's how we view it. But we're ready to help the customer or another customer and make sure that drug gets back in the market.

Tycho W. Peterson

Analyst, JPMorgan Securities LLC

Thank you.

Eric Mark Green

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

Thank you, Tycho.