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West Pharmaceutical Services, Inc. (WST)

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MANAGEMENT DISCUSSION SECTION

David Howard Windley
Analyst, Jefferies LLC

All right, good afternoon, everybody. Thank you for being here. I'm Dave Windley with Jefferies Healthcare Equity Research. Hope you got your coffee or your afternoon caffeine injection of some sort. We are moving into our next presentation which is going to be a fireside chat with the management team of West Pharma Services, ticker they're WST.

With me today is Eric Green, the company's CEO and President; and Bernard Birkett, the company's Chief Financial Officer.

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QUESTION AND ANSWER SECTION

David Howard Windley
Analyst, Jefferies LLC

Q

So, Eric, I'm going to start off just thinking about the overall kind of structure of the opportunity here and I think you've been very consistent with a 6% to 8% growth rate type of target for quite a long time. We went through a couple of year period where performance was a little slower than that and in some ways unpredictable. First quarter really performed quite nicely. How would you characterize the demand environment and, maybe as important, your visibility into your clients' order patterns and therefore stability of that demand environment?

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

A

Yeah. So, first of all, David, thank you for the invitation for us to participate in your conference. It's been a very, very productive day. Dave, I just want to just recognize a couple of my colleagues with us: David Montecalvo, who's our Chief Operating and Supply Chain Officer; and also Quintin Lai, who heads IR.

But you're absolutely correct. When you take a look at the markets that we operate in, we truly believe that the 6% to 8% organic growth rate corridor is the performance level we should expect out of West on an annual basis as we look at the construct of the company.

When you think about, you break that down, it's roughly the market unit volume consumption is roughly around 2% to 3% from a volume perspective. We are able to get a net price contribution at least 1% globally. And then we have a mix shift really driven by the high-value product portfolio which has given us 3% to 4%. And when you aggregate that together, it gives us the 6% to 8%. There is some variability from quarter to quarter and you pointed that out in Q1 where we had a little over 11% organic growth in the business again. Primary driver of that growth has been the high-value product portfolio.

The underlying markets that we serve continues to be robust and that's the thesis that we're building our business off of. We believe in the Pharma segment which is roughly around 30% of our business. It's small molecules. It's roughly – volume is relatively flat. We expect that business to grow slightly better than the markets in low single digits.

When you think about the generics business, we see that market between 3% to 5%, and our expectations of that business is high single digits. And then the biologics business, which is roughly a little over 20% of our business, that's growing well in the double digits. We believe the market volume consumption is anywhere between 4% and 6%. So that's how, on the proprietary side of our business, we see the growth profile going forward.

I'll comment briefly about the visibility into the business that we have. We put a tremendous amount of energy and effort and resources into building better analytics in the business. It starts with the commercial organizations with the segmentation of the markets and having the analytics to look at, not just past trends, but also future projections based on discussions with our customers. So we're continuously getting closer to our customers to have those conversations. Fortunately, West is on majority of the molecules that are being developed and commercialized in the marketplace. So, we're in a very good position to have that visibility.

Secondly, on our global operations and the supply chain, we are working with really our top customers with supply chain, the supply chain interaction, and we're getting better visibility and predictability of their launches, and then

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the continuation of follow-up after launch, after adoption into the marketplace. So, we're gaining better visibility. And as Bernard brings to the table better analytics for the organization, and I'm feeling pretty confident we have better visibility as we go forward.

David Howard Windley
Analyst, Jefferies LLC

Q

So, in building that visibility, is that – just trying to understand the nature of that. Is that a relationship-building exercise and just having more conversations with clients? Is it a digital connectivity element where you're more interconnected and order patterns are, I don't know, more real-time? What are the building blocks of those interactions?

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

A

Yes. I think the thrust of this has been the confidence our customers have given us over the last year or two as we globalize our operations in regards to our cycle times of delivering our products to our customers to a make-to-order concept. And because we're able to bring those down into levels that are the best that we've done at West for many, many years gives our customers confidence that we have better controls around our supply chain.

Because of that, we're now having the monthly interactions about exchanging demand profiles. What we see based on historical data and what our customers are predicting based on their launches and also the uptick on the particular molecules. So, it's a combination of both, but it really is a – it's sharing of information at the supply chain level, which has been enhanced I guess I would say from the West point of view.

David Howard Windley
Analyst, Jefferies LLC

Q

Okay. And then thinking about tailwinds in terms of innovation in the pipeline kind of separate from or outside your control. Under Scott Gottlieb, the FDA has become more prolific in its approval patterns. And as a general statement, the shift in mix toward injectable-type medicines has been a pretty steady factor. To what degree should we interpret a 59 approval year by the FDA as a very acute significant tailwind for your business?

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

A

Well, in particular, when you speak of the biologics, you see more of approvals and it's a very positive impact in the West business because of our success hit ratio on the new molecules. And particularly in the biologic space, we're seeing an increase in interest obviously with our Crystal Zenith platform. We are continuing to see the number of launches being prepared over the next 12 or 18 months in that particular portfolio.

We have seen an increase in interest in our NovaPure product portfolio that we launched a couple of years ago which has taken time for our customers to put on stability tests to ensure that as they move towards the NovaPure, which is quality-by-design concept, that the – whether it's an existing molecule in the product line or new products come into the product line that there's confidence of stability and performance. And we're seeing that at this point in time, so we're really more confident as we look into the latter part of 2019 but going into 2020 with these parts of the portfolio. So it's exciting to see the efforts of new product launches are certainly gaining traction. But as you indicated, it does take time to penetrate and to get adoption into the marketplace and particularly with the injectable medicine space.

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David Howard Windley
Analyst, Jefferies LLC

Q

Is there a – because you mentioned NovaPure and I wanted to key on that for a second. It seems highly relevant to biotech as a general statement but is it also more specific than that in terms of the particular class of molecules or a particular regulatory regime or something like that? NovaPure is kind of the highest point of the pyramid in terms of the advancement or the complexity of the package that you're offering, but then also the pricing margins to you for that as well. I know it's small. Put it in context how big NovaPure is or how meaningful it is to the business, and is there a sustained tailwind that can drive that doubling of growth in NovaPure like you saw in the first quarter?

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

A

Yeah. I think when you look at the history of the portfolio of new products within high-value products portfolio growth, it does take several years before we get larger penetration, i.e. 10%, 15%, 20% of the portfolio. So, when you think about NovaPure, what's exciting about that it's – again, it's quality by design. It has been historically targeted towards smaller biotechs and some smaller emerging companies. And so we're seeing that gain traction. And if you think about the number of molecules, what percentage of molecules are coming from the smaller customers versus the larger customers, it's actually quite significant. So, that's one area of growth.

We're also seeing a growth of existing customers who want to make NovaPure more of a portfolio play of their biologic portfolio. So, it's an adoption. It's taken some time. It's taking about two or three years to get more traction. It's early but it's becoming meaningful when you start thinking about $10 million to $15 million per quarter of revenue.

David Howard Windley
Analyst, Jefferies LLC

Q

Okay. So, we talked about all these nice tailwinds the first quarter that we should touch on was a strong growth quarter, 11 percentage top line. You've maintained – I think nothing wrong with that – but maintaining the 6% to 8% revenue growth target, so maybe talk about the factors as you move through the year that then result in a slower growth rate in the first quarter through the balance of the year.

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

A

Well, maintaining with the guidance is there were two aspects from revenue. First, we absorbed the impact of Vial2Bag where we excluded that from our guidance for the remainder of the year and then take our guidance down. That was approximately $11.3 million. And then on the FX side, we're facing increased FX headwinds and with the euro obviously weakening against the dollar, and that was about a $4 million to $7 million incremental impact. So again, that was absorbed into the guidance. So for us to say that we didn't or we just maintained is...

David Howard Windley
Analyst, Jefferies LLC

Q

Not apples to apples.

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

A

Yes, it's not apples to apples exactly. You've got to take those two things into account.

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David Howard Windley
Analyst, Jefferies LLC

Q

Okay. And the FX just to be clear on that, the FX update was that as of the end of first quarter?

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

A

Yes, end of the first quarter.

David Howard Windley
Analyst, Jefferies LLC

Q

And have we seen – it seems like we've seen some additional headwinds since then.

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

A

There has been some. I think the euro bounced back a little bit yesterday. So we just have to see how it transpires for the fourth quarter.

David Howard Windley
Analyst, Jefferies LLC

Q

Okay. As we think about the margin part of your long-term story which is also quite attractive, there is an element of that it seems from just the natural shift in mix toward these high-value products which will carry progressively wider margins. But then also to your global operations point earlier, some very specific deliberate actions that you're taking to kind of take cost directly out. Could you talk about the relative contributions of those things and maybe to use a baseball analogy, what inning are we in in those things?

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

A

Okay. So, David, you're absolutely correct. There's a couple of levers that we're seen on the margin expansion. One is when you look at a high-value product growth, when you think about a high single-digit, low double-digit growth, that is approximately 40 to 60 basis point expansion on the gross margin level. And that's what we're experiencing with that portfolio and we expect that for the balance of the year.

The second lever that we have is around our global operations. About two years ago, we made a decision to globalize the operations from historically 20 manufacturing sites somewhat independent of one another for all the right reasons for historically. But we found that opportunities to better service our customers, increase quality, increase a global network approach would really drive down some of the cost of our infrastructure.

What you're seeing today with the global operations, I would say it's early innings but the last four quarters and proprietary, we've seen healthy margin expansion. The gross margin level really driven a combination of high-valued product growth but also in the global operations.

A couple of key drivers out of that as an example. When we added the Waterford site a year-and-a-half ago, that moved our number of sites up to 29 manufacturing sites. At the end of this year, we will have 25 sites that will be operating for West because of the work the global operations team has done is to identify areas of opportunities to consolidate existing facilities into other facilities That allows us to level load and leverage our existing assets more effectively.

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Like I said, we are early in stages with the global operations strategy. Thinking about how we are going to invest in our centers of excellence, particularly around the high-value products. We have built out significant capacity over the last several years. So, when you think about our CapEx and deployment of CapEx, it will be more towards new growth initiatives versus lots of bricks and mortar. So, when we guided down to about $120 million to $130 million a year, we really have taken the capital that we've spent on assets between 11% to 12% of sales. We're approximately around 6% [audio gap] (00:14:38) to 7% of sales at this time, and again directly contributed to the global operations.

Roughly around two or three quarters ago that we'd take in the contract manufacturing business where we need to improve on the margin expansion and we rolled it into the global operations. So, today, when we look at global operations, it's the complete network across the globe and, actually, quite excited about the future prospects that continue to drive. When you think about safety, think about quality, think about service to customers and around cost, those are the key benefits we're going to get from this global operations approach.

David Howard Windley
Analyst, Jefferies LLC
Q

So, the contract manufacturing point there is a good segue. That is a business that has done remarkably well, driven a lot of growth, certainly, I guess higher than I would have expected, maybe higher than you guys expected at some point in the not-too-distant past. Could you talk about what the drivers are there and the sustainability of that? I know you've guided for that

to moderate, but help us understand a little more specifically how much moderation or is there really a kind of multi-year tailwind still behind that business?

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

Well, there's two ways looking at it. One is you're absolutely correct to believe the strategy to move more towards the healthcare product portfolio versus having a mix of health care and consumer products. So, today, well, less than 10% of the business in contract manufacturing is consumer products, which is highly – it's very, very [indiscernible] (00:16:18) In the healthcare area, the growth that we've seen really is in the diabetes space over the last couple of years. And it's not just one product or one customer, it's multiple products and it's multiple customers.

So, we've added capacity and capabilities both in Europe and also in the U.S. to support that growth. When we installed the capacity, it's taking us time with this new technology and new capability in automation to ramp up and get full utilization. We've been working on that for the last 12, 18 months. We believe that we'll be at more our capacity latter part of this year.

Now, saying that, that has driven a lot of growth in the contract manufacturing business and our focus is really going back towards how do we leverage the existing assets to put in there and get more margin expansion over the next several quarters. So, the growth rates we believe will be more in the mid-single to high-single-digit growth based on the existing capacity that we've added. And also, we believe margin expansion is going to get back to – I should say the gross margin get back to what we used to produce about a year-and-a-half to two years ago.

David Howard Windley
Analyst, Jefferies LLC
Q

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So you mentioned ramping capacity and to my ear it sounded like you were talking about call it PP&E type capacity. I think there was a period where maybe there was a kind of a rush on the training ramp that was – and putting things in place for clients as they needed them. It was hard to be efficient in that, and so cost ballooned to some degree. Do I misremember that? Was that a people thing or a PP&E thing and to what degree has that been solved at this point?

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

A

It's both. So, PP&E was more about installing the capacity and getting the productivity levels up to closer to 100% utilization. In order to get the operations up and running, there was an influx of resources. Human capital really did drive the productivity gains and we were to see over the next period of time. So that's starting to normalize at this point in time. And while we're normalizing that, we're also getting more yield out of existing capacity. So, it's a two-pronged approach which is really going to drive that margin expansion that we're talking about.

David Howard Windley
Analyst, Jefferies LLC

Q

Okay. Coming back to Vial2Bag, you talked about absorbing that into the guidance and I think perhaps that was a luxury that you have because of the first quarter was so strong. My interpretation of your comments was not so much that your expectation around Vial2Bag revenue had changed that much but just there was an opportunity to take that out of the guidance and not have that overhang for lack of a better word. Is that is that right or has the kind of the visibility to returning Vial2Bag to market deteriorated a little bit?

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

A

I don't think it's a visibility against deterioration. We're just working through a process with the regulators to make sure that we get the product back on the market as quickly as possible. What we didn't want to have is any surprises as we – or excuses later in the year when we start to compare it against our overall targets. We felt that we could take it out of our guidance and still meets the growth rates that we had projected. If perhaps it did return in 2019 then that would be a tailwind. But what we didn't want to have is any ambiguity as we get through the year. So, again as we said, as we got through the first quarter, we're able to absorb not having that in our forecast and still meet our targets.

David Howard Windley
Analyst, Jefferies LLC

Q

Right. So, you said it more elegantly than I but I think I heard you correctly. I wanted to go more specifically on capacity and utilization. So, you talked about the Waterford facility being 29 and ending this year at 25. But I think we're to interpret that that hasn't necessarily reduced your kind of peak productive output necessarily. Where are you in some of the newer facilities? Where are you in terms of capacity utilization and at this lower CapEx level – for how much longer can we maintain this lower CapEx budget before you do need to think about putting more brick and mortar on the ground?

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

A

Yes. So, there's a couple of levers that we're looking out. One is you're obviously correct Waterford we're ramping up as we speak. We have started commercial production late last year. We expect that to go throughout 2018. But we've been pretty clear that we'll break with our Waterford plant as far as in the middle of or to the end of

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2020. So, it was a headwind. It became less so as we go forward and we're really encouraged by the number of customers that toured and validated products that were moving into the Waterford site.

Saying that, we have capacity available in Waterford. We also have capacity available in Kingston. I was just there last week. We're continuing a great progress and be able to produce over a period of product portfolio out of Kingston. And it also has given us the ability to offload some of the volume pressures that we're getting and some other plants like Jersey Shore Pennsylvania. That is what Kingston today is less than 50%. So, we do have facilities that are operating capacity. We have some new facilities or less [indiscernible] (00:22:13) at this point in time.

We believe over the next five years, based on our current footprint, an even reduce in the footprint with four sites, we have the appropriate bricks-and-mortar to get us through the growth trajectory that we have. Now, in saying that, there is another area that we're looking at is around automation. So, driving more robotics into the facility so we can drive higher quality, higher yield, lower footprint utilization for the same amount of units as part of productivity.

So, it is – this is a two-pronged approach. I'm very pleases on how the global teams looking at, allocating capital on new technologies, new processes which are the very – much better payback – softer payback time than bricks-and-mortar which is where our focus should be on for the next three to five years.

David Howard Windley
Analyst, Jefferies LLC

Q

And just to put a final point on that last comment. The automation investments, would you anticipate that those could be captured within a CapEx budget at approximately at the level today?

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

A

Yeah.

David Howard Windley
Analyst, Jefferies LLC

Q

And then your point there, is that those automation investments could stretch your capacity beyond the five-year timeframe that you've just referred to.

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

A

Correct.

David Howard Windley
Analyst, Jefferies LLC

Q

Okay. Maybe as a final question here. the company has cash flow and – has generated cash flow – cash on the balance sheet not really taking out any additional leverage to the point that you're in a pretty balanced cash debt position. As that turns into an increasing net cash position, what would your capital deployment priorities be for that cash?

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A

Eric, do you want to...

Eric M. Green

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

A

Well, we're – obviously, we would look at opportunities to strengthen our business. We have some strategic initiatives that we're assessing and looking at potential acquisitions. But our main focus is really on delivering the 68% organic growth and ensuring that we get 100 basis points operating margin improvement. So, anything we do will not detract from that. So, that is the primary focus for us. But again what we have to look at how we strengthen our business over time, look at the areas that our customers are looking for us to get involved in to provide them with better service. But again it's really taking a disciplined approach to acquisitions to make sure that they fit within the construct that we've already set out.

David Howard Windley

Analyst, Jefferies LLC

Very good. But we're out of time. Thank you very much for joining us. And we'll break out downstairs. I think – no breakout. Sorry. No breakout on this one. Thank you very much for joining us.

Eric M. Green

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

Thanks, David.

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