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West Pharmaceutical Services, Inc. (WST)

Q2 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the Q2 2016 West Pharmaceutical Services Earnings Conference Call. At this time, all participants are in a listen-only mode. Later we will conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions] As a reminder, this conference is being recorded.

I would now like to introduce your host for today, Vice President of Investor Relations, Mr. Quintin Lai. Please go ahead, sir.

Quintin John Lai
Vice President-Corporate Development, Strategy & Investor Relations

Thank you, Andrew. Good morning and welcome to West's second quarter 2016 conference call. We issued our financial results this morning and the release has been posted in the investors section on the company's website 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 provide an updated financial outlook for the full year 2016. There's a slide presentation that accompanies today's conference call and a copy of that presentation is also available on the investors section of our website.

Going to slide two, there's a Safe Harbor statement. Statements made by management on this call and in the presentation will contain forward-looking statements within the meaning of U.S. federal securities laws and that are based on management's beliefs and assumptions, current expectations, estimates and forecasts. Many of the factors that will determine the company's future results are beyond the ability of the company to control or predict.

These statements are subject to known or unknown risks or uncertainties, and therefore actual results could differ materially from past results and those expressed or implied in any forward-looking statement. For a non-exclusive list of factors, which could cause actual results to differ from expectations, please refer to today's press release as well as any further disclosures the company makes on related subjects 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 margins 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 earnings release.

I'd now turn the call over to West's President and CEO, Eric Green.

Eric Mark Green

President, Chief Executive Officer & Director

Thank you, Quintin. Good morning, everyone, and thank you for joining us today. As we stated in our press release, we had another solid quarter and are well-positioned for the remainder of the year.

Looking at our financial performance, the company generated reported second quarter sales of $388 million, on a constant currency sales growth of 8.2%. The growth was broad-based across all market units and geographies. Adjusted operating margin was 15.4%, equaling the record high we set last quarter and 150 basis points better than the prior year quarter. All of this led to Q2 adjusted diluted EPS of $0.59, which is a 26% increase over the prior year quarter.

I am pleased with how our market-led strategy is taking shape. The key pillars of that strategy are customer experience, operational excellence and product and service expansion. And I'll be highlighting in my remarks several activities that our Commercial, Global Operations and Innovation and Technology teams are executing.

Turning to slide four, looking at our sales performance, we had solid contribution from both of our segments. Sales of Proprietary Products grew 8.9% organically, driven by double-digit growth in Generics and high single-digit growth in Biologics and Pharma. Our high-value product portfolio which represents over 50% of segment sales grew 17% organically.

Similar to the trends last quarter, we experienced strong customer demand across the high-value products spectrum, particularly for Westar products, Daikyo components, FluroTec products and increasing adoption of NovaPure offerings that ensure the highest standards of quality and performance.

Contract-Manufactured Products, which represents about 20% of overall sales, grew 5.1% organically, an uptick from the first quarter growth level. Sales of drug delivery and diagnostic products more than offset continued softness in consumer products. We have good momentum heading into the second half of 2016 as our teams are ramping up tooling activities to support additional projects that will commence in Q4 later this year and into 2017.

We have stated that a key strategy for the company is to become even more market-facing and improve customer experience. A key initiative in Commercial is to engage with customers to provide them with valuable technical and scientific information in support of the selection and use of drug containment and delivery systems.

During this quarter, West focused on providing this technical engagement in the fast-growing Asia-Pacific region. We held several seminars in China and India, with more than 200 customers in attendance, providing insights about market trends, challenges in selecting containment solutions for injectable medicine and strategies for selecting prefilled delivery systems for best patient outcomes. I am pleased on how our commercial organization is engaging with our customers and creating value.

Turning to Global Operations on slide five, we generated a gross profit margin of 34.4%, a new record high and an increase of 160 basis points from the last year. In addition to product mix shift to high-value products with expanded margins, we made good progress with our manufacturing throughput and improved efficiencies through lean initiatives across our global network.

Over the course of the second quarter, I visited 13 locations across Asia, Europe, South America and the United States, and I'm pleased on how our market-led strategy and key initiatives are being embraced and implemented throughout our operations. In fact, I had the opportunity to see firsthand how we drive operational excellence in our plants to continuously improve safety, quality, delivery and cost.

I want to share a few areas that our Global Operations team is focused on and the results we are seeing. The first is quality. As you know, we placed a high emphasis on working with our customers to address their quality needs. As a result of our initiatives, we have reduced other spec products by more than 33% year-over-year.

To dimension this achievement, of the 32 billion components that our proprietary segment sells each year, we have achieved an out-of-specification metric of well under 100 parts per 1 billion sold. Needless to say, quality remains a key differentiator for West and we continue to raise the bar.

As we stated in the last quarter's call, our Global Operations has been working to reduce order lead times to our customers. We're now seeing shorter lead times across our network, and as a consequence our backlog is down from peak Q1 levels. We expect further lead time improvements in the back half of the year and a reduction of year-over-year backlog growth which will better match our core demand.

During my travels, I also visited our state-of-the-art facility now under construction in Waterford, Ireland. The project remains on-time and within budget. As you can see from this recent photo, phase 1 includes this impressive building in the foreground, which will house new capacity to manufacture sheeting material for cartridges used within insulin pen injector systems, expected to be online for commercial sales in early 2018.

Turning to slide six, earlier this month, Amgen announced that it received FDA approval of its Repatha drug for use with our SmartDose technology platform. I'm proud of our Innovation and Technology team for achieving this milestone. Our team continues to work with Amgen, as they prepare for an August commercial launch in the U.S. For West, this marks just the beginning for our integrated injectable drug delivery strategy.

When you look at Amgen's monthly dosing system for Repatha, you see a product combining several of our proprietary containment and delivery technologies. We continue to see strong interest by our customers in our on-body drug delivery technology, including several customers that are currently evaluating SmartDose.

Repatha also marks the third FDA approved use of Crystal Zenith containment technology over the last 12 months. We continue to work with several customers to test CZ technology with their drugs in formal stability studies and are working with numerous customers that are conducting early-stage evaluations.

Turning to slide seven, I want to highlight a new product line [ph] that's (10:13) important to our customers' success. While SmartDose and Crystal Zenith get a lot of attention, the vast majority of our sales and products come from our components business. And this business has been growing as we continue to introduce new high-value products to meet our customers' needs for a high quality [indiscernible] (10:33) containment and delivery of their important drugs.

The newest member of our high-value product family is the 1-3mL NovaPure plunger. We're seeing a trend towards larger volume injections beyond typical 1 mL applications, especially for new biologic therapies in auto injectors. We have introduced a new 1-3mL plunger developed using Quality by Design principles. The NovaPure platform is the highest standard of quality in our portfolio.

Turning to slide eight, and the outlook for the balance of 2016, our teams have responded well to the realignment of our organization at the start of the year and have embraced our market-led strategy. We have two good quarters under our belt, and we're well-positioned as we enter the second half of the year.

Therefore, we are raising our organic sales growth outlook for the year to 7% to 9% compared to a prior outlook of 6% to 8%. We're also raising the lower end of our adjusted EPS guidance range, which is now $2.15 to $2.25, an increase over a prior year of 17% to 23%.

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

William J. Federici

Chief Financial Officer & Senior Vice President

Thank you, Eric, and good morning everyone. We issued our second quarter results this morning, reporting net income of $44.7 million or $0.60 per diluted share. Our reported results this quarter include $0.01 per diluted share reversal of a portion of our previously provided restructuring reserve. Excluding this restructuring activity, our adjusted earnings per diluted share was $0.59 this quarter, $0.12 above the $0.47 per adjusted diluted share earned in the second quarter of 2015.

Turning to sales, slide 10 shows the components of our consolidated sales increase. Our consolidated second quarter sales of $388 million increased by 7.9% versus our second quarter 2015 sales. Excluding the $1.2 million adverse currency effect, our Q2 2016 sales increase increased by 8.2%.

Proprietary net sales increased 8.9% versus the same quarter 2015, excluding exchange. Sales price increases accounted for 1.1 percentage points of the sales increase and the favorable mix of products sold and volume increases contributed the remainder of the increase.

Sales of our high-value products rose 16.6% versus the prior year second quarter. Current quarter HVP sales as a percentage of total Proprietary Products sales increased by 3 percentage points versus a year ago. We continue to see strong customer demand for our product offerings that meet our customers' high quality expectations.

The combined Q2 revenues from CZ and SmartDose of approximately $5 million, were $3 million less than the combined 2015 Q2 sales, reflecting the lumpiness of customer sampling demand. Contract-Manufactured net sales increased by 5.1% versus the prior year quarter, ex currency.

As provided on slide 11, our consolidated gross profit margin for Q2 2016 was 34.4% versus the 32.8% margin we achieved in the second quarter of 2015. Proprietary's second quarter gross margin of 38.5% was 1.5 margin points higher than the 37% achieved in the second quarter of 2015. The increase in gross margin is due to modest price increases, the favorable mix of sales and lower raw material costs, offset by normal inflationary increases in labor and overhead.

Contract-Manufactured's second quarter gross margin increased by 1.2 margin points to 17.6% due to the favorable mix of products sold and volume increases, offset by higher labor and increased overhead cost associated with new capabilities supporting contract-manufacturing customer programs.

As reflected on slide 12, Q2 2016 consolidated SG&A expense increased by $1.7 million versus the prior year quarter. Merit-related increases in compensation costs and higher pension expenses were partially offset by lower stock and incentive comp costs. As a percentage of sales, second quarter 2016 SG&A expense was 16.1% versus 16.9% in the second quarter of 2015.

Slide 13 shows our key cash flow and balance sheet metrics. Our year-to-date operating cash flow is $3.6 million above what we generated in the first six months of 2015, due primarily to our higher earnings and lower current year pension plan funding. Our capital spending was $74 million for the first six months of 2016, approximately $17 million more than at this time in 2015.

We expect to spend $150 million to $175 million in capital in 2016. Approximately 50% of 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 June 30th of $203 million was $72 million less than our December 2015 balance. The decrease reflects the February 2016 $68 million payment at maturity of our Euro B notes. Additionally, we have made $17 million of purchases under our stock buyback program.

Debt at June 30th of $231 million was $67 million less than at year end, reflecting the Euro B notes repayment. Our net debt-to-total invested capital ratio at quarter end was 2.5%. Working capital of approximately $420 million at June 30th was $60 million higher than at year end. The majority of the increase is due to increases in our accounts receivable and inventory balances.

Looking ahead, our backlog of committed Proprietary Products orders stands at $417 million at June 2016, 20% higher than at June 2015, excluding exchange. However, as expected, the June 2016 backlog is about $30 million less than its January 2016 peak.

Based on our year-to-date 2016 results and our analysis of the orders on hand, we've revised our full year 2016 guidance in this morning's release. Our guidance is summarized on slide 14.

We believe that 2016 quarterly results for our business will follow historical seasonality, wherein results for the third quarter are traditionally lower than the results achieved in our first and second quarters due to customers and our plant summer shutdown.

We have raised our proprietary revenue guidance and our expectations for proprietary gross profit margin to reflect the increased demand for our high-value product components. We now expect organic sales growth for the full year 2016 to be in the range of 7% to 9%.

Our revised guidance also reflects a reduction of Contract-Manufactured Products' gross profit margin due to a higher percentage of low-margin development [indiscernible] (18:34) agreement and the anticipation of future commercial orders and less labor and overhead absorption in certain Contract-Manufactured plants due to the timing of customer programs.

Other items affecting our revised EPS guidance are increased SG&A spending to support our growing business and a higher share count driven by increased option exercise activity. We now expect full year adjusted diluted EPS to be in the range of $2.15 to $2.25. We've based our guidance on an exchange rate of $1.12 per €1, which is the same rate used in our prior guidance.

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

Eric Mark Green
President, Chief Executive Officer & Director

Great, thank you, Bill. In conclusion, we delivered another solid quarter with momentum for the balance of the year. Our teams are making progress executing on our growth strategy and more importantly the feedback from customers has been extremely positive. We believe we are building on a position of strength, continuing to deliver value for our customers and for our shareholders.

Andrew, we're ready to take questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And I'm sure we have a question or comment coming from the line of Paul Knight from Janney.

William March
Janney Montgomery Scott LLC

Q

Hey guys, this is actually Bill on behalf of Paul. How are you doing?

William J. Federici
Chief Financial Officer & Senior Vice President

A

Good. How are you Bill?

Eric Mark Green
President, Chief Executive Officer & Director

A

Thank you, Bill.

William March
Janney Montgomery Scott LLC

Q

Doing well. First question, you kind of highlighted the market-led strategy. How has that maybe helped your conversations with customers? And then specifically looking at the growth that you're seeing in Generics, how are their demands different from some of the other customers, and how do you migrate them up towards high-value products?

Eric Mark Green
President, Chief Executive Officer & Director

A

Yeah, Bill, thank you for the question, and absolutely. So the market-led approach is actually we are starting to see traction in the conversations we are having with our customers. Just to reiterate, we have aligned our commercial organization really around the Generics, the Biologics, Pharma and we also have contract-manufacturing.

And what we're identifying is, we're creating value proposition that allow our product portfolio to be better aligned to the customer needs. A great example was the recent launch of the 1-3mL NovaPure plunger, which clearly supports the Biologics' customer base with the need of larger volume for injectable medicine in auto injectors. So we're seeing good traction.

I would also articulate – I'd say that the teams are more focused on getting more insight information from the customers on the needs, which really lends itself into your second question about Generics. One thing that we're learning about Generics, is that the need of high-value products is actually more important than we originally thought, because we have a team that's just dedicated for Generics, they're having conversations with the customers on a daily basis.

What we're seeing is, the growth in Generics is really driven by the high-value product portfolio, which obviously is higher margin, higher sales and longer stickiness. And the reason for that, the fundamental reason is speed to market. They're looking to get their drug on the market fast and the high-value product portfolio allows them to get approval by the regulatory bodies faster than just the standard products. So that's a good example on this new market-led approach and the traction that we're gaining in the marketplace.

William March
Janney Montgomery Scott LLC

Q

Great. And then just a follow-up, looking at the improvement in gross margin, if you look at the bridge, 80 basis points is from kind of lean [ph] initiatives seems (22:42), what's driving that improvement? And as we think about margin expansion opportunities at West, how should we maybe think about efficiencies versus volume and mix? Thanks.

Eric Mark Green
President, Chief Executive Officer & Director

A

Yeah, so I'll start with the first section and [ph] then ask (23:01) Bill Federici add some more color. So when you look at – we made a change, West has a very strong manufacturing footprint globally with 28 sites around the world. But the one change we made in the early part of the year is, we actually pulled together the Global Operations under one team. And what we're experiencing at this point, it is a concerted effort, focus around lean initiatives.

And so to give you an example, our contract manufacturing business for several years has been really driving lean principles. We actually are taking those concepts and started spreading that globally to our sites. I mentioned earlier, I had the opportunity to travel to all our – most of our locations around the world.

When I was in Europe, one of the most impressive changes I've noticed over the last year is that when you go to the different plants, there's really clear initiative to drive continuous improvement, which is driving costs out of the system. So I think you're going to continue to see opportunities for us to expand margins, not just product mix, and a little bit of price, but really it's going to come from lean principles and make sure it's a part of our DNA going forward at West. Bill?

William J. Federici
Chief Financial Officer & Senior Vice President

A

Yeah, I agree with everything Eric said, Bill. And just to put a little more flavor around it, efficiencies are important and we will continue to see, as Eric said, margin expansion coming from that. But as a reminder, our growth equation is predominantly a mix equation right now.

We have a little bit of price helping the margin, a big lift coming from not only introduction of new products that are requiring our high-value products, especially from the Biologics area, but as Eric said earlier, the migration from standard product to high-value products coming from our Generics customers. We really see that as being the number one driver of the margin expansion going forward being augmented by good efficiency and lean in our plants.

William March
Janney Montgomery Scott LLC

Q

Great. Thanks, guys. I will get back.

Eric Mark Green
President, Chief Executive Officer & Director

A

[ph] Thank you, (25:06) Bill.

William J. Federici
Chief Financial Officer & Senior Vice President

A

[ph] Thank you, (25:09) Bill.

Operator: And our next question or comment comes from the line of Tim Evans with Wells Fargo Securities. Your line is now open.

Tim C. Evans
Wells Fargo Securities LLC

Q

Thanks. Bill, I think earlier in the year, you've kind of said that you were targeting $40 million-ish for kind of Crystal Zenith and SmartDose in the year. Does your early experience with the product that was approved give you comfort in that target?

William J. Federici
Chief Financial Officer & Senior Vice President

A

Yes, absolutely, Tim. We're seeing that while the quarter itself was short of last year's second quarter for CZ and SmartDose, that's the nature of our business right now, most of it being of a sampling origin. But as we continue to look at the backlog of committed orders from our one customer on SmartDose as well as those other customers for CZ and some development activity that we have relative to the [indiscernible] (26:13) both SmartDose and CZ, we feel comfortable in that $40 million target.

Tim C. Evans
Wells Fargo Securities LLC

Q

Okay. And then, the second one was on, I guess there was a little bit of a reversal of your restructuring charge from Q1, what should we read into that? Are you [ph] decided (26:31) to do a little less or what's going on there?

William J. Federici
Chief Financial Officer & Senior Vice President

A

It's accounting, I hate to be an accountant and have to explain something like this. But, you know the way the accounting works, at the beginning of the plan, once the plan is approved and you have site to the plan, you disclose the entire plan, but you're only allowed to take the income statement charges as it relates to the actual activities happening.

So severance for instance, you take that, we set up a provision at the first quarter reflecting what our guesstimate was at that based on the activities that we had. And in one of our geographic locations, the actual number of persons that are affected by this has gone down slightly due to, one, some people left on their own accord; and two, we have – in certain locations, you have the knock-on effect, where a senior person can displace someone below them and end up with less severance for us.

So, bottom line is, it's an accounting enigma that we have a reversal of a provision that was set before. We will have as you know and we've said it before, we will have additional expenses that we will provide for in Q3 and Q4, as we continue to progress the restructuring plan.

Tim C. Evans
Wells Fargo Securities LLC

Q

Okay. And then the last one, your tax rate for the first half of the year has been fairly materially below your guidance for the full year, which suggest that there's going to be a pretty meaningful step up in the back half, is that the correct interpretation?

William J. Federici
Chief Financial Officer & Senior Vice President

A

No, I think what you should take into it is that, we believe that the [ph] management rate (28:29) that is the rate without all of the special charges for restructuring, et cetera, and benefits from those will be in that 28% – 28.5% range. And the increase from the prior year is really reflective of an increase in the geographic mix of earnings. So we're earning more money in places like the U.S. and Germany and we will continue to do so, basically driven by high-value products. And we believe our best guess at this point in time is 28.5% for the rest of the year.

Tim C. Evans
Wells Fargo Securities LLC

Q

For the rest of the year. Not for the full year?

William J. Federici
Chief Financial Officer & Senior Vice President

A

For the full year.

Tim C. Evans
Wells Fargo Securities LLC

Q

Got it. Okay. All right. Thank you.

William J. Federici
Chief Financial Officer & Senior Vice President

A

Thank you, Tim.

Operator: And our next question or comment comes from the line of Derik DeBruin with Bank of America. Your line is now open.

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

This is Juan Avendano on behalf of Derik.

William J. Federici
Chief Financial Officer & Senior Vice President A

Hi Juan.

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

Congrats on the quarter and on the approval of the first drug with the SmartDose. And so I actually wanted to start with the SmartDose. Wondering if you could provide a comment – an update on the next-generation SmartDose, the one that comes with the prefilled syringe, any customer feedback and any potential timeline of anybody or any customer starting potential studies with it?

Eric Mark Green
President, Chief Executive Officer & Director A

Juan, thank you for the comments and the questions. So, we're in early stages of development at this point with the next-generation with customers. I'd tell you it is on schedule. What we're seeing is, an increased interest to have a device that is pre-filled, so two components, and we're having several discussions with our customers. So the interest level is good. But I would say that we're on schedule and it's going to take a few years before we start seeing uptick with this next-generation.

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

Okay. Good. And if I may go back to the first question regarding the market-led strategy. So, in this quarter, if I compare the growth rates that you experienced, particularly in Pharma and Generics, they were higher than the long-term growth rates that would have been expected based on your 2016 Analyst Day this year. So Generics did double-digits as opposed to like the long-term expectation of mid-to-high single-digits, and Pharma did high single-digits versus low-to-mid single-digits. And so my question is now that you've had this market-led strategy for a few months, has there been a change towards a more improved outlook on these markets in the long-term?

Eric Mark Green
President, Chief Executive Officer & Director A

No, I wouldn't say there's been a change. I think what you're seeing is a little bit of a variance between quarter-to-quarter. But if you look at the full year, in particular look at 2016, we feel good about looking at double-digit growth both on Generics and Biologics units and mid-single for our Pharma.

In addition, just to add on to that, our contract manufacturing, as we've said, is picking up momentum, we believe mid-single for contract manufacturing also. So it's a little bit of a variance between quarter to quarter. We have good line of sight with our customers. I think the market-led approach has given us better visibility on demand – future demand, therefore our confidence level is rising.

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

Q

Okay. That was it. Thank you.

Eric Mark Green
President, Chief Executive Officer & Director

A

Okay. Thank you.

William J. Federici
Chief Financial Officer & Senior Vice President

A

Thank you, Juan.

Operator: And our next question or comment comes from the line of Dave Windley with Jefferies.

David Howard Windley
Jefferies LLC

Q

Hi, good morning, gentlemen. Thanks. So, Juan took one part of my SmartDose question. The other part was just customer response. Now, that you've gotten the kind of the headline of an approval, what kind of reaction from the customer base have you seen on the heels of that, if any?

Eric Mark Green
President, Chief Executive Officer & Director

A

Yeah, Dave, I think the way to address that is that once the announcement came out, there's been an increase of conversations with key customers. What we've learned in our business over the years is that once you have approval on new technology or even new components, the interest level goes up. So we're seeing an increase on interest of both SmartDose and CZ, and that we believe will continue to go forward as this product launches.

David Howard Windley
Jefferies LLC

Q

Have you quantified, and if not can you quantify what you expect your, call it, stable revenue or run rate revenue for SmartDose supply for this most recent approval would be?

William J. Federici
Chief Financial Officer & Senior Vice President

A

[indiscernible] (33:43).

David Howard Windley
Jefferies LLC

Q

I guess there are some contingent factors there, but.

William J. Federici
Chief Financial Officer & Senior Vice President

A

Yeah. And Dave, you know we're under a confidentiality agreement with our customers. So we don't talk about volumes.

David Howard Windley
Jefferies LLC

Q

Okay. Are the two approvals of CZ products trending in line with expectations?

Eric Mark Green
President, Chief Executive Officer & Director

A

Yes, Dave. They are in line with expectations and also where we are in stages of various formal stability tests – testings are going on right now. We think the pipeline is strong and in line consistent to what we've communicated [ph] for this forecast (34:21).

David Howard Windley
Jefferies LLC

Q

Okay. And then shifting to facilities. Eric, you talked about the 28 facilities in lean manufacturing, and then there was also Tim's question on tax rates. So, I'm curious about looking at the slide with Waterford on – you said construction is on track. I guess I'm curious about how completion of that facility happens, I think there's some activity already ongoing there perhaps, and then how you migrate business into Ireland in a way that will re-route or redirect profitability of the company into your Irish operations that would then flow through to tax rates? So, kind of a multi-faceted question there.

Eric Mark Green
President, Chief Executive Officer & Director

A

Yeah, Dave, that's a good point. So we're really focusing on creating centers of excellence, especially around our high-value products portfolio. And in Europe we have selected, while we do manufacture in Germany, in France and a few other locations of our high-value product portfolio, we're focusing to concentrate the next-generation, next level of quality out of our Waterford facility.

To start with, we are going to be manufacturing and we haven't started by the way, just construction commenced [indiscernible] (35:45) premise completed, and we'll be doing testing for our customers in 2017 with first commercial dollars early 2018. But it's really around the insulin sheeting as the first phase. And then the second phase we will be starting to put in more high-value products finishing. And that allows us to move commercial revenues through that entity going forward. I'll let Bill comment on implications on the taxes.

William J. Federici
Chief Financial Officer & Senior Vice President

A

Yeah. So, I think Dave, the key point that Eric made is important is that, this is really driven by the customer demand for higher-quality products. So we are putting these centers of excellence in, the first one will be in Ireland, and we think there will be one maybe in Singapore, would allow us to meet the high level demands of our customers for higher-quality product.

And yes, we will be – as new customers come on and once that facility is up and running, which probably won't be until 2019-2020 timeframe, so [indiscernible] (36:52) way out there, there will be revenues that will be naturally recorded in that country. There will be an ancillary benefit of having the corporate tax rate there is 12.5% as you know, which is less than our global rate and certainly less than the U.S.

But the primary focus of those centers of excellence again is to drive a high-quality product and be able to meet those very, very high quality demands from our customers. And lastly, this tax impact that you're talking about won't take effect until we actually have commercial revenues, which wouldn't even start until 2018.

David Howard Windley
Jefferies LLC

Q

Right. Okay. So, [ph] gearing (37:38) that out, you've got testing in 2017, commercial revenue in 2018...

William J. Federici
Chief Financial Officer & Senior Vice President

A

Yeah.

David Howard Windley
Jefferies LLC

Q

...building that up, and then would it be right to think that you don't really visit a tax strategy behind that that would be kind of a lagging...

William J. Federici
Chief Financial Officer & Senior Vice President

A

Yes.

David Howard Windley
Jefferies LLC

Q

...activity relative to the ramp of the revenue?

William J. Federici
Chief Financial Officer & Senior Vice President

A

Absolutely. Absolutely. So as the revenue ramps, I think it's actually corollary, right? As the revenue ramps, we believe it will be our highest value products being pushed through that plant, because that's what the customers demand, and therefore higher profits, lower tax, should generate a lower tax rate on that.

David Howard Windley
Jefferies LLC

Q

Right. Right. Okay. I'll it at that. Thank you.

William J. Federici
Chief Financial Officer & Senior Vice President

A

Great. Thanks, Dave.

Operator: [Operator Instructions] And our next question or comment comes from the line of Larry Solow with CJS Securities. Your line is now open.

Larry S. Solow
CJS Securities, Inc.

Q

Hi, good morning, guys.

Eric Mark Green
President, Chief Executive Officer & Director A

Good morning, Larry.

Larry S. Solow
CJS Securities, Inc. Q

I joined a little late, just juggling a couple of calls, so I'm not sure if this question was asked. But just on the – I noticed you guys on your prepared remarks talked about certainly the initiatives to improve throughput and reduce the lead times is certainly starting to gain some traction. Can you just sort of give us an update on where you stand, is there still a lot more low-hanging fruit or improvement you expect over the next couple of quarters? And this backlog number of 20%, could you sort of maybe guesstimate where it would be without the sort of earlier ordering or increased ordering earlier on? Thanks.

Eric Mark Green
President, Chief Executive Officer & Director A

Sure. Larry, let me start by saying that with these lean initiatives, I mean we're obviously pushing to be part of the, I call the DNA of the organization. So we're really focusing on especially in our high-value product manufacturing plants, identify ways to decouple some of the processes, so we can be more efficient with the assets we currently have on the ground.

Larry S. Solow
CJS Securities, Inc. Q

Right.

Eric Mark Green
President, Chief Executive Officer & Director A

So this is really driving that mindset around ROIC, looking at delivery times for our customers. And so we're seeing early signs of success, but this is a journey. It's going to take some time, but I think there's opportunities as we look at our facilities around the world.

And I think as we talked about a little bit earlier about a center of excellence concept, now we have a great opportunity to make sure that the processes we put into Waterford are the leading cutting-edge that gives us [indiscernible] (40:19) efficiencies, the highest quality and, in fact, service, and [indiscernible] (40:23) quality and service to our customers. So we have room for opportunities to continue to improve, Larry. I think Bill if you want to touch here?

William J. Federici
Chief Financial Officer & Senior Vice President A

Sure. On the current backlog situation, you're absolutely right, Larry, it has come down from the peak, January peak was about $450 million, it's about $30 million less than that now.

Larry S. Solow
CJS Securities, Inc. Q

Right.

William J. Federici
Chief Financial Officer & Senior Vice President

A

So we are seeing good progress as Eric mentioned along that curve, but there is still room to run. We are seeing the desired effect of customers not having to place orders as far in advance...

Larry S. Solow
CJS Securities, Inc.

Q

Okay.

William J. Federici
Chief Financial Officer & Senior Vice President

A

...as there has been, which caused that backlog to increase. So we expect that this number will continue to go down. So as we see anniversarying comparing it to the prior year, we'll see the growth number come down.

Larry S. Solow
CJS Securities, Inc.

Q

Right.

William J. Federici
Chief Financial Officer & Senior Vice President

A

...the growth over the prior year and sequentially we think we will actually see the dollar amount of the backlog come down. What that exact number is, Larry, is very, very difficult to tell. As we've said in the past, it really depends on a number of things, when the customer places the order, each year a customer may have different things going on in their own shop.

They may have been looking at some kind of change in their own product portfolio, and therefore may be ordering in advance or waiting to order further later, so it really is a customer by customer analysis. We can say anecdotally that we know that it's higher than it should be, but an exact number to put on is to suggest what the right number is, is a guess. And I would say that's somewhere in the mid to high $300 million would be...

Larry S. Solow
CJS Securities, Inc.

Q

Got it.

William J. Federici
Chief Financial Officer & Senior Vice President

A

...where I would place a normal amount of backlog for our Proprietary Products.

Larry S. Solow
CJS Securities, Inc.

Q

Got it. I appreciate that. And I realize it's a challenge and somewhat of a guess.

William J. Federici
Chief Financial Officer & Senior Vice President

A

Yeah.

Larry S. Solow
CJS Securities, Inc.

Q

Okay, great. Just lastly on the – I know you tweaked your gross margin expectations I guess or consolidated remain the same and proprietary a little higher, and I assume that's just getting better traction and then better sales in the high-value product. The tweak down on the contract manufacturing side, is that just some temporary inefficiencies, and I realize that's relatively a small number on the tweak down on the gross margin, but any color there would be great? Thanks.

William J. Federici
Chief Financial Officer & Senior Vice President

A

Yeah. So, it's really reflective – it's what you said. It's really reflective of – it's such a small number. When you have tooling and development revenues which is what we expect to come in the back half of them, you'll see a less of a margin on those. You don't get the same margin you would on a commercial product.

But the good news is that, that's a, what we believe an anticipation of actual commercial orders increasing for those customers since they're doing development activities with us. So while it does have the effect of less overhead absorption and therefore lower margins, we believe that it's still a positive. We still feel very comfortable with the mid-single growth rate for the Contract-Manufactured product business and we believe that their margins will continue to grow due to a mix shift and lean.

Larry S. Solow
CJS Securities, Inc.

Q

Got it. Okay, great. Thanks guys. I appreciate it.

Eric Mark Green
President, Chief Executive Officer & Director

A

Thank you, Larry.

William J. Federici
Chief Financial Officer & Senior Vice President

A

[indiscernible] (43:46).

Operator: And at this time, I'm showing no further questions or comments. So with that said, I'd like to turn the call back over to Mr. Quintin Lai for closing remarks.

Quintin John Lai
Vice President-Corporate Development, Strategy & Investor Relations

Thank you for being on this call and on the webcast. An online archive of the broadcast will be available on our website three hours after this call and the replay instructions are in the press release. Thank you and have a good day.

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