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West Pharmaceutical Services, Inc. (WST)

Q1 2018 Earnings Call

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Dana Flanders
Analyst, Goldman Sachs & Co. LLC

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the Q1 2018 West Pharmaceutical Services Earnings Conference Call. At this time, all participants are in a listen-only mode. Following the anticipated remarks, we will host a question-and-answer session and our instructions will be given at that time. [Operator Instructions] As a reminder, this conference call may be recorded for replay purposes.

It is now my pleasure to turn the conference over to Mr. Quintin Lai, Vice President of Investor Relations. Sir, you may begin.

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

Thank you, Brian. Good morning and welcome to West's first quarter 2018 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, give you an update on our business and provide an updated financial outlook for the full-year 2018. 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.

On slide 2 is the Safe Harbor statement. Statements made by management on this call and in the presentation contain forward-looking statements within the meaning of U.S. Federal Securities Law. These statements are based on management's beliefs and assumptions, current expectations, estimates, and forecasts. There are many factors that can influence the company's future results that are beyond the ability of the company to control or predict. Because of these known or unknown risk or uncertainties, actual results could differ materially from past results and those expressed or implied in any forward-looking statement.

For a non-exclusive list of factors which could cause actual results to differ from our expectations, please refer to today's press release as well as any further disclosures the company makes regarding the risks to which it is subject in the company's 10-K, 10-Q, and 8-K reports.

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

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

Eric Mark Green

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

Great. Thank you, Quintin, and good morning, everyone. Thank you for joining us today. This morning, we recorded our first quarter performance and you have seen in our press release we grew overall sales despite the headwinds in a tough first quarter comparison that we've forecasted at the beginning of the year.

Our Generics market unit posted another quarter of accelerating growth and our Contract-Manufacturing segment also saw impressive growth in the quarter. There are positive signs of future growth across all market units and we are confident in the underlying strength of our business as we look to the remainder of 2018.

Let's now turn to the detail of our market unit performances for the first quarter. On slide 4, we showed the organic sales growth performance of each of the three market units in our Proprietary Products segment and our Contract-Manufacturing segment.

As we have done on previous calls, we show the trailing four quarters along with the current quarterly performance. While we adjust for last year's sales associated with both the deconsolidation of the Venezuela business and lower consumer contract manufacturing sales due to a customer moving their business in-house, our organic sales growth would have been 4.1%.

I'll start with Generics which represents an excellent example of the resilience of our business. Looking back, we saw the first signs of a slowdown due to customer inventory management beginning in late 2016. By Q3 of 2017, we started to see early indications of return to normal growth. Since then, we have reported accelerating growth for the past three quarters. Order patterns from our largest customers give us confidence for the rest of the year. Another encouraging sign is a strong rebound in sales growth we are seeing in India.

On the new product front, we are encouraged to see numerous sampling requests for our AccelTRA Component Program, a high-quality product offering that is built around the most critical and fundamental customer needs for quality, speed and simplicity. We're also seeing increased customer activity around our patient-controlled self-injection platform, SelfDose, as companies seek technologies that make it easier for patients to self-inject. These and other initiatives are seeding the market for future growth. For the full-year 2018, we expect Generics' organic sales growth in the high-single digits.

Turning to Pharma, the sales growth pattern is similar to what we saw with Generics over the past two years. Pharma customer inventory management issues impacted results beginning in 2017. But our order book has stabilized now and we expect to see sales growth acceleration for the remainder of the year.

Within the Pharma market unit, there is increase in demand for a universal vial transfer system. To address this, we are adding manufacturing capacity for a Vial2Bag administration system. And this capacity comes online throughout the year. It will contribute to the anticipated growth we expect. We're also encouraged with the outlook of HVP adoption of FluroTec, Westar RS, Envision and NovaPure components.

For Pharma, we're planning for mid-single-digit organic sales growth for the full year with a balanced revenue stream throughout the year.

Looking at Biologics, the past two quarters illustrate the quarterly variability primarily driven by launch plans as well as active stock adjustment programs at large customers. Our strong double-digit growth in Q4 was aided by commercial launch activities that did not occur in Q1. To address the challenges we have experienced with inventory management activities of our customers, we have been working closer with the supply chains of our larger customers to better anticipate the timing of demand.

Understanding the complexities of these supply chains is leading to better transparency, and in fact, helps us forecast last quarter that Q1 would be soft for Biologics. Using the same methodology, we see a more stable outlook for Q2 in Biologics and accelerating growth for the remainder of the year. We are making good progress with the supply chain partnership program.

Given the start in Biologics, full-year growth will likely be in the mid-single to high-single-digit growth range. However, as we look to the future, we remain confident in the strength of this business. We continue to maintain our strong market position with excellent participation on FDA new molecular entity approvals. Our high-value components are the go-to standard for Biologics and biosimilar customers, and demand is building and forecasted to grow throughout the year.

High-value product adoption remains a key focus for Biologics and for all our market units. We're seeing good adoption rates for NovaPure components, Envision-inspected components, and our administration systems.

These products are key to addressing the challenges our customers are facing across all market units. They represent our highest-quality offerings and therefore yield better margins for the business. We expect high-single to low-double-digit growth for our HVP portfolio for the full year.

Turning to contract manufacturing. We had another strong quarter of sales growth. Our CM team is doing a great job of providing our customers with expertise in high precision, high volume injection molding and assembling. A great example is our recently expanded Dublin, Ireland facility. Just a few weeks ago, I toured the facility and was impressed with the level of activity. It was less than two years ago when we expanded to a second building. Now, that building is running on all cylinders and we're looking to meet growing demand with further expansion within our current footprint.

At the same time, our businesses continue to evolve to meet the needs of our customers we serve. As an example, we have recently added new capabilities such as cold storage drug handling in Arizona and will soon be installing the same technology in Ireland. These new capabilities accelerate our strategy to provide strategic and high-valued products and services for our CM customers. We expect continued progress in 2018 with high-single-digit growth for the year.

While our commercial team continues to engage customers on what is most important to them in terms of products and services, as noted on slide 5, our operations team is also focused on improving the customer experience across all segments and units. Our unified global manufacturing team is working across all our sites to improve safety, quality and service to our customers while reducing overall costs.

We're seeing good progress on each of our key performance metrics, and our previously announced restructuring program is on track.

We're looking forward to delivering the first commercial sales in our newly constructed Waterford site in Ireland later this year. We're also working to transfer high-value product technology to Waterford, so we can serve customers even more fully from this state-of-the-art site in the future.

Waterford is now part of our unmatched global manufacturing footprint through which we are delivering industry-leading lead times with the highest level of quality. I'm especially pleased to see how our teams are working to continuously improve our performance in the future to exceed our customers' expectations.

With Q1 behind us, we're well positioned for the remainder of 2018. We are reaffirming our full-year 2018 organic sales growth guidance of 6% to 8% and we are reaffirming our overall sales and adjusted EPS guidance.

Now, I'll turn it over to our CFO, Bill Federici, who will provide more color on our financial performance and to provide details on our long-term outlook. Bill?

William J. Federici

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

Thank you, Eric, and good morning, everyone. We issued our results this morning reporting first quarter 2018 earnings of $43.6 million or $0.58 per diluted share versus the $0.81 per diluted share we reported in the first quarter of 2017. Our Q1 2018 reported results included $3.3 million or $0.04 per diluted share of restructuring and other charges, resulting in adjusted diluted earnings per share of $0.62.

Our financial results are summarized on slide 6 and the reconciliation of non-GAAP measures are described in slides 12 to 14. Our Q1 2018 reported results also include $2.1 million or $0.03 of EPS tax benefit associated with share-based payments, whereas Q1 2017 included $15.9 million or $0.21 EPS tax benefit.

Our results for Q1 2018 were impacted by the new revenue recognition rules and the new pension expense classification rules. While the new pension rules had no net impact on EPS, the new revenue recognition rules accelerated the recognition of certain of our revenues. The adverse impact to our Q1 2018 sales was $3 million, and we expect the full-year adverse sales impact will be approximately $6 million. Our working capital has been and will continue to be adversely impacted by the acceleration of revenue recognition. The adverse impact on Q1 working capital was approximately $3 million for two days.

Turning to sales, slide 7 shows the components of our consolidated sales increase. Consolidated first quarter sales was $415.7 million. Excluding the currency translation effects and the effects of the deconsolidation of our Venezuelan subsidiary and the lost consumer-product contract manufacturing customer, our consolidated Q1 2018 sales would have increased by 4.1% versus the prior-year quarter.

Proprietary Products sales increased 1.3% versus the same quarter in 2017 excluding exchange effects and the effects of the deconsolidation of our Venezuelan subsidiary. Sales price increases accounted for just over 1% of the sales increase in the current quarter. Our high-valued product components and system sales decreased 2.2% versus the prior-year quarter. While our Generics market unit business saw a return to high-single digits in the current quarter, as expected, the current quarter's HVP sales were adversely impacted by customer inventory management, especially in our Pharma and Biologic market units. The current quarter's HVP sales as a percentage of total proprietary sales were essentially flat versus the prior-year quarter and represented more than 55% of our total Proprietary Product Q1 2018 sales.

For the full-year 2018, we expect high-single to low-double-digit sales growth in high-valued products. CZ and SmartDose sales were $9 million in the current quarter versus $8 million in the prior-year quarter. Contract-Manufactured Product net sales increased by 7.9% ex-currency versus the prior-year quarter, despite the loss of a consumer product business customer.

A favorable mix of products sold, volume increases and pricing drove the increase in Q1 2018 sales. This quarter's growth was favorably impacted by continued strong demand for some customer projects in our Dublin facility. We expect high-single-digit sales growth in contract manufacturing for the full-year 2018.

As provided on slide 8, our consolidated gross profit margin for Q1 2018 was 32.3% versus the 34.6% margin we achieved in the first quarter of 2017. Excluding the adverse effect of the deconsolidation of our Venezuelan sub, the lost consumer products contract manufacturing customer and the under-absorbed overhead in Waterford, our Q1 2018 gross profit margin would have increased 20 basis points versus the prior-year quarter.

Proprietary Products first quarter gross margin of 37.1% was 220 basis points' lower than the 39.3% achieved in the first quarter of 2017. The decrease in gross margin is due to the unfavorable mix of products sold, the under-absorbed overheads in Waterford, the Venezuelan deconsolidation, partially offset by increased prices and operational efficiencies in other facilities.

Contract-Manufactured Products first quarter gross margin decreased by 150 basis points to 14.8% compared to the prior-year quarter. The current quarter's lower gross margin is primarily due to the adverse effect of the lost consumer product customer, partially offset by the favorable mix of products sold and operational efficiencies in our Dublin facility.

As reflected on slide 9, Q1 2018 consolidated SG&A expense increased by $5.9 million versus the prior year quarter. As a percentage of sales, first quarter 2018 SG&A expense was 16.4% versus 16.1% in the first quarter 2017.

Foreign currency exchange increased SG&A expenses by $2.3 million. We also experienced higher compensation expense including merit increases and increased outside service costs, offset by less SG&A associated with the deconsolidation of our Venezuelan operations in Q2 2017.

Slide 10 shows our key cash flow metrics. Operating cash flow was $45 million for the current quarter, $24 million more than the prior-year quarter, primarily reflecting a $20-million voluntary pension contribution made in the prior-year quarter.

Our capital spending was $28 million in the current quarter. We expect to spend less than $150 million in capital in 2018. More than half of our planned capital spending is dedicated to new products and expansion initiatives.

Slide 10 also provides some summary balance sheet information. Our balance sheet continues to be strong, and we're confident that our business will provide necessary future liquidity.

Our cash balance at March 31 of $200 million was $36 million less than our December 2017 balance. Approximately $48 million of our cash was used to buy back 540,000 shares of our common stock under the board-authorized share buyback plan, yet at March 31 of $198 million is roughly the same level as at the year-end. And on a net debt-to-total-invested-capital ratio basis, we are essentially delevered.

Working capital of $480 million at March 31 was $16 million higher than at year-end. The majority of the increase is due to the decrease in our cash balances being more than offset by increases in our receivables related to the growth of our business and the impact of the new revenue recognition accounting rules, as well as less accounts payable and accrued expenses at this quarter's end. Our committed proprietary product orders of $428 million at March 2018 were 11% higher than at year-end, but 3% lower than the March 2017 orders excluding exchange due to the current reduced order lead time.

Turning to slide 11, we are reaffirming our full-year 2018 sales and EPS guidance range, reflecting the favorable Q1 2018 foreign currency exchange rate offset by less Q1 2018 excess tax benefit on stock transactions than we had previously anticipated. We expect our 2018 full-year effective tax rate to be approximately 26%, excluding the impact of the tax benefit from option exercises. Despite the euro exchange spot rate increase to $1.22 per euro, we have conservatively based our guidance on an exchange rate of $1.20 per euro, the same rate used in our prior guidance. Our 2018 guidance excludes any expected additional expense associated with our restructuring program.

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

Eric Mark Green

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

Thank you, Bill. Before we close, I want to share some customer feedback. We recently hosted a panel of global customers representing all our business segments and market units. We asked these customers to provide feedback on our performance and what makes for an ideal industry partner. They talked about the criticality of high quality, security of supply and scientific excellence, and we're pleased that West rated highly on all those fronts.

Importantly, they talked about wanting a partner who could help them differentiate their products to offer more value to patients. They want flexible dosing, wearable devices, connectivity, digitization, and innovation. They're also looking for suppliers that understand both the long drug development cycle and the need for speed and flexibility and how best to partner along the way.

At West, we are proud of our long-standing partnership with the injectable drug industry that these customers represent. In fact, earlier this month, we celebrated our 95th year in business. And while we have celebrated that milestone, our focus is on what the next 95 years will bring and how we can continue to grow our business into the future.

As we look to the rest of 2018, our focus is on execution. We are working with our customers across all the markets to deliver products and services that meet their unique needs. Our global operations team is working to improve safety, quality, and service for customers while reducing our overall costs, and we're anticipating the future and what our customers and their patients will need as we develop new products and new capabilities to service them.

Our market-led approach is resonating with our customers, and we're confident we will continue to see future grow for the remainder of the year.

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

QUESTION AND ANSWER SECTION

Operator: Thank you, sir. [Operator Instructions] And our first question will come from the line of David Windley with Jefferies. Your line is now open.

David Howard Windley
Analyst, Jefferies LLC

Q

Hi, guys. Thanks for taking my questions here. I wanted to try to understand a little bit better on sales growth, as you might imagine. Follow your – I was looking at the slide around your tracking of growth by end market segment and thinking about how you get from the 0.2% in the first quarter to the 6% to 8% for the full year. And if you could just kind of walk me through that, perhaps particularly focusing on Biologics, but walk me through that by client segment would be very helpful. Thank you.

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

A

Yeah. David, good morning. Thanks for the question. Let me start with the Biologics area, as we've commented on, is that this particular part of the business, we're seeing some variability because of when the customers are buying high-valued products, sort of the clinical Phase III evaluations such as line trials or part of the delivery system or even build strategic inventory in advance of anticipated approvals. So, when the launches occur, there is a buildup and then there's somewhat a delay until a replenishment of inventory. So, we're seeing a little bit of variability in the Biologics.

Saying that, we are pretty confident when we start looking at the order book and future projects we're currently working on in Q2, Q3 and Q4, that gives us confidence that we're going to be able to drive a organic performance of mid-single to high-single digits for the full year.

In the Pharma sector, that particular market unit, if you strip out the headwind they had in Q1 specifically around Venezuela, which not all, but a good portion of the Venezuela operations was under Pharma. And as you know, when that shut down with minimal revenue coming back to West going into that market with those operations not working.

So, we started thinking about the Pharma uptake on the high-valued products. We also see the administration system business a little over capacity constraint today will be additional capacities online starting this quarter. And we'll be able to able push that through to our customers who are pulling the demand today from us. So, the Pharma, we're feeling much more comfortable that we'll be back to our typical growth rates and when we will look at the revenues, it's more stabilized each quarter versus that fluctuation.

Just to finalize on the Generics. The Generics has come back as we anticipated, but actually a little bit stronger than originally but the outlook is even greater. The reason why I would say it's a little stronger than we anticipated, we didn't anticipate India to come back as fast as it did in Q1. That was a very strong performance. In fact, all of Asia was well, very, very strong growth across all of Asia-Pacific for us.

So, we believe that Generics space will continue to deliver as we've seen this quarter and going forward. So, if you bring that all together, that gives us a little bit higher than that 6% to 8% corridor for our Proprietary, so the full average for the full year is 6% to 8%.

I'm not going to say much about contract manufacturing, that's pretty much isolated, you can see it. But Dave, last comment, high-value products is the key driver of that growth. So, as we look at into the next three quarters, looking at growth rates of high-single, low-double digits with our high-valued product portfolio.

David Howard Windley Q
Analyst, Jefferies LLC

So, just to clarify, I mean, numerically, from a basically zero starting point in the first quarter, a lot of your guidance kind of hovers around high-single to low-double. Don't you need solidly double digits to drag the average up to 6% for the year?

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

Yeah. Yes, you do, Dave. So, that's what we're...

David Howard Windley Q
Analyst, Jefferies LLC

And...

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

Yeah, that's what we're looking at is if you look at the pacing of the quarter, it's building up towards that. But back half of 2018, it's going to be much stronger than we had in the first half. And there's a little bit of a comp issue, too, when you started thinking about the back half of last year...

David Howard Windley Q
Analyst, Jefferies LLC

Yeah. Okay...

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

[indiscernible] (26:27). Yeah.

David Howard Windley Q
Analyst, Jefferies LLC

And then, maybe one last one, then I'll yield to others. On the qualitative side, just thinking about you've had this impact to lead times and inventory. We've talked for several quarters about how there were bottlenecks that you addressed. But during the bottlenecks, clients overbought and built inventory. And then, once you addressed them, there's kind of a tough comp aas they're lapping those activities.

And I think those are more Generic-biased, but we've also kind of used those same types of descriptions in Biologics. And I think, qualitatively, the issues are different, right? Because in Biologics, it sounds like your issues are, are clients launching product or not, is that delayed, do you have visibility on that. And I guess – help me to understand. Am I right that kind of the nature of the two issues is different such that like our confidence that we're going to lap the issues in Biologics is different and maybe not as high as the simple lapping of the Generic issue?

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

A

Yeah. Dave, it's a very good observation. That's a good – so, when you think about the Generics, you're right, a lot of the bottlenecks that occurred a year and a half, two years ago was around our high-valued product portfolio and conversion of Generic customers to that part of our portfolio. And because of the fact that we weren't able to produce, the lead times escalated significantly.

I would say, we have lapped that clearly in the Generics space. We're actually delivering at new record cycle times that it's faster than anybody in the industry today. So, when you think about the Biologics, you're absolutely correct when you said it's a little bit different than the Generics. It's still the high-valued product portfolio, but a large component of that is the build up for launches and then the drug acceptance into the marketplace. That's what we're seeing.

But I can assure you what we've learned with the Generic customers, those are our top customers where we put our supply chains together. We're now mapping out demand curves required for their largest launches. So, it gives us better anticipation not just in Generics but now in the Biologics space. So, there is some of that confidence that we're seeing in the Biologics space. Yes, the cycle times are much less, you don't need to order as much in advance. But the larger portion of that is really around drug launches, the cyclicality of that.

David Howard Windley
Analyst, Jefferies LLC

Q

Okay. All right. As promised, I'll step out. Thanks.

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

A

Great. Thank you, Dave.

Operator: Thank you. And our next question will come from the line of Larry Solow with CJS Securities. Your line is now open.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Great. Thanks. Good morning, guys. Just a follow-up on the backlog question. You guys have done a great job obviously reducing lead times. And historically, backlog was sort of somewhat of an indicator of future growth with some nuances obviously, especially more lately. Does the fact that you're basically flat year-over-year, does your forecast entail more – even more and greater customer conversations? In other words, how do you sort of see yourself growing eventually low-double digit this year when your backlog is kind of flattish?

And then, the second question would be now that you have more capacity, have discussions sort of opened up around sort of changing some customers, some of the existing products, older products getting more into the HPV and our high-value stuff on that – on those ends?

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

A

Yeah. Larry, those are good questions. Thank you. So, the first one, you talked about backlog. You're absolutely correct. What you've seen – well, what we've seen today is a different profile of the backlog. And what I mean by that is historically we'd have pretty much visibility. It's pretty even dispersed over the next three or four quarters.

What we're seeing now, even though it's flat, a higher proportion of that backlog number is more near term, i.e. if I look at today, it can be Q2 and Q3, and it goes to the fact that the cycle times are less. Customers are less prone to put orders in long term. It doesn't mean that they're looking at alternative sources. We are on those molecules. We are their supplier of choice for their products that have been launched. It's just we are able to perform at a much higher level than we had in the past. And again, that is due to lean initiative, it's due to the capacity expansion that we have in place today that gives us that platform.

So, I'm confident when you start thinking about the backlog as more near term than long term. That's the changing dynamic. The capacity conversation, you're right, Larry, we are in active conversations with our customers, moving them from standard products to high-valued products.

And while some customers are taking a platform approach and we're moving more of their molecules towards that, some are looking at it one at a time. We are adding – when you think about Waterford as an example, while we're – we have a facility that have been validated by our customers where we can add commercial ramp-up, we're continuing to add new technologies like Westar RU in Waterford. We have a more complete solution to drive the quality. So, these are the initiatives that we've put in place to convert our customers from standard to high-valued products.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Okay. And just a question on sort of cadence of growth, you can go out through the year, I know you guys don't guide quarterly. But it sounds like maybe a little bit of improvement in Q2, but most of the sequential improvement really occur in Q3 and then into Q4. Is that sort of good assessment?

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

A

Yes, Larry. I think you'll find consistent growth around the Generics. Pharma, as I mentioned, will be more consistent from a revenue perspective. But on a comp perspective, you'll see it accelerate as a percentage because the cost is less than 2017. And Biologics will see a continued acceleration throughout the year.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Okay. Great. Thanks.

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

A

Thank you, Larry.

Operator: Thank you. And our next question will come from the line of Dana Flanders with Goldman Sachs. Your line is now open.

Dana Flanders
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thank you very much for the questions. I guess my first one and just following up on just the cadence throughout the year, can you just talk a little bit about just the gross and operating margin progression that we should expect? I mean, will that generally follow revenue growth, or is there any lumpiness that that we should be thinking about in terms of just margin improvement throughout the year?

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

A

Yeah. Dana, thank you. Yes, it will be more progressive as the year goes. It was as we said, a very tough comp in the first quarter as we go through the year with both high-valued product expansion and the growth and sales expansion as we talked about. We believe that margins will get better as the year progresses. So, yes, definitely back half ended and progressing as the year goes.

Dana Flanders
Analyst, Goldman Sachs & Co. LLC

Q

Yeah. Okay. Great. And then just...

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

A

That's both for gross margin and for operating margin.

Dana Flanders
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Great. And just my second quick follow-up, just on the bigger picture on competition, I believe a few of your larger competitors have announced investment in expanding capacity. Just how are you thinking about the supply/demand equilibrium in the medium term across standard products, across high-valued products and just I guess the potential for competition on new business? Thank you.

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

A

Yeah, Dana, we're aware of our competition are continuously – or they're investing in certain parts of their business. What we're looking at – again, just putting it into perspective, the volumes that we've produced today a little over 40 billion components a year. And to get a site up and running, you're seeing this with us at the Waterford and we started that project in 2014, right? And so, here we are talking about customers just validated the lines and we're starting to put into commercial revenues for the balance of 2018.

Our process is pretty consistent to other companies that would have to – as the building and validation doesn't really change. Said that, we are aware that they are building capacity. We are having active discussions with our customers to continue to move up the high-valued product curves, so that as you started thinking about differentiation, it really is around the quality. It's around availability of good service which we believe that we just, in the last 12 to 18 months, have significantly raised the bar. So, we're not complacent. We understand the situation, but we do believe that we will continue to be in a very, very favorable position because of those levers.

Dana Flanders
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Operator: Thank you. And our next question will come from the line of Paul Knight with Janney Montgomery. Your line is now open.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

Hi, Eric. When is Waterford coming on line?

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

A

Yeah. Well, Paul, we have – right now, we're validating products with customers. They're actually sent with samples. They're working through the changes that will occur from manufacturing other locations to our Waterford facility on the existing products but also new products. It's obviously a validation process.

In Q3, we're looking at revenues – commercial revenues, and that will be really the official – it will launch and grow as we proceed throughout the quarters. I have to tell you I've been there a few times. The site is really, really well positioned. Our customers are very complimentary of what we've done, next is to replicate current processes but to really move them into the next generation. So, I think there's a lot of interest. And we have a lot of visitors on site for future business, so Q3 and forward.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

And then, the burn year or – how – what is this burning up on SG&A for the interim here per quarter?

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

A

Okay. Bill?

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

A

So, Paul, it really impacts more COGS. The under-absorbed overhead was $3.6 million in the quarter. We'll see a similar amount in the second quarter. But as you remember, we discussed last year, we started depreciating the plant in the second quarter. So, you'll start to see that under-absorbed overhead, as it's comparable to last year, will start to abate. And as we start to get some of the commercial activities in Q3 and beyond, that number – the unabsorbed overhead will lessen as we go through the year.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

And lastly, CapEx, you're saying down this year below $150 million. What's it look like after this year?

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

A

Yeah, Paul, I have to tell you, one of the changes we made about a year and a half ago was – and we've always thought about our operations globally, but we've really formalized the global operations, and we have 28 manufacturing sites. And by formalizing the global approach, we're able to allocate our resources, I would say, probably more effectively on where we want to invest in centers of excellence.

And also, we look at capacity, we've built out Kinston. We have Waterford on the ground. We have expanded in Dublin. We have bricks and mortar. And so, this year, we're looking at below $150 million. We believe, going forward, we'll be hovering around that corridor. And as a percentage of sales, it will continue to drop.

Right now, just to put it in – to dimension it, right now, we're looking at about $50 million to $60 million of our CapEx is around maintenance. And if you want to maintain the high level of quality and the productivity of our facilities, that's the investments we have to make, we're putting about $20 million into IT as a combination of some maintenance but also future growth. And the balance is really around new products and new innovations and new HVP portfolios that are coming into the market. That's how you would look at the split.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

Okay. Thanks.

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

A

Thank you, Paul.

Operator: Thank you. And our next question will come from the line of Drew Jones of Stephens, Inc. Your line is now open.

Drew Jones
Analyst, Stephens, Inc.

Q

Thanks, guys. Looking at the core Proprietary Product revenue, down about 2% year-over-year. Can you parse out how much of that was volume versus how much was mix and is it safe to assume that the volumes are going to rebound in the back half of the year? I know you talked a lot about HVP being a key driver from here, but I just want to get a feel for the volumes bouncing back other than just easier comps coming up.

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

A

Yeah. We do obviously believe that the volumes will continue to grow from all the things that Eric described earlier. We don't parse out volume and mix other than where we talked about high-valued products was also down in the quarter. But as Eric commented, we believe, for the full year, we will see high-single to low-double digit growth of high-valued products. So therefore, you can assume we're going to continue to accelerate not only volume-wise but also mix-wise.

And remember, our construct is only – it's about 1% price, 2% to 3% market volume and then the rest is mix. So, while we didn't see a whole lot of growth in the first quarter, Eric mentioned we don't know see any lost business and we're going to continue to grow this business in the way that we believe that construct makes sense for us. So, more growth coming in the back half of the year obviously, but both volume, mix and a little bit of price.

Drew Jones
Analyst, Stephens, Inc.

Q

Perfect. And then, on the contract manufacturing side, you talked about losing the consumer – customer, filling that with the healthcare lines. What's your line of sight for when that's going to stop being a drag on margins?

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

Well, just real quickly. The consumer business that we lost and they brought in-house themselves, that will be in the full year of 2018. So, we ended that relationship at the end of 2017, literally at the end of 2017 and will have an impact – somewhat an even impact throughout 2018. I have to say, though, that when you start talking about high-single-digit performance, even with that that particular loss, it's pretty impressive because of the strategic focus around the healthcare space is driving that performance. Bill, if you want to add.

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

Yeah. Just one extra thought on there. There's two components to the piece that impacted Q1. The one is, obviously, the margin on the products sold. But then, there's the under-absorbed overhead that it leaves in its place when you take the product out. As part of the restructuring plan that we talked about, we are going to be combining those two contract manufacturing facilities in the U.S. into one.

And that will happen in the latter part of 2018, the second half. And therefore, you'll see that under-absorbed overhead piece of that issue go away. So, less of a drag in the back half of the year, but as Eric said, the strong growth in healthcare is definitely a net positive for that business going forward.

Drew Jones Q
Analyst, Stephens, Inc.

Thanks, guys.

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

Thank you.

Operator: Thank you. And our next question will come from the line of Derik de Bruin with Bank of America. Your line is now open.

Derik de Bruin Q
Analyst, Bank of America Merrill Lynch

Hi. Good morning.

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

Hi, Derik.

Derik de Bruin Q
Analyst, Bank of America Merrill Lynch

Hey. Hey, Bill, just a question. I mean, when you sort of look at second quarter and where exchange rates are, what's sort of embedded in your model for FX on 2Q and then also for the balance of the year? I mean, 7% in Q1 was well above what we had modeled.

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

Yeah. Yeah. So, you're right that Q1 was $1.23 per euro through the first quarter. The rest of the year, we've scheduled it at $1.20. Even though the spot rate today is $1.22, we took a conservative stance on the FX growth. So, if you remember the paradigm, a $0.01 change once in the ratio for the full year would yield about $0.01 of the EPS. So, our previous guidance have been at at $1.20. We left it there for now. There is some benefit in the first quarter, and we're being conservative by just saying that we'll be at the $1.20 for the rest of the year. So, in the second quarter, using the $1.20, you should expect about $0.04 of EPS expansion versus the prior year.

Derik de Bruin
Analyst, Bank of America Merrill Lynch
Q

Okay. And so, that was about the same rate than in the first quarter, about $0.04 benefit...

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

No. It's a little higher than that, Derik, because it was at $1.23, not $1.20.

Derik de Bruin
Analyst, Bank of America Merrill Lynch
Q

Got you.

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

So, in the first quarter, it's $0.07.

Derik de Bruin
Analyst, Bank of America Merrill Lynch
Q

$0.07 FX. Got you.

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

Yes.

Derik de Bruin
Analyst, Bank of America Merrill Lynch
Q

Thank you. And I'm just sort of curious on – you're – basically, you've got this very clean balance sheet and sort of like how are you guys thinking about utilizing that going forward? I mean, is there more indication to sort of lever up just a touch to maybe be a little more aggressive on buybacks? I'm just curious in terms of what is – I mean, it doesn't sound like – I mean, you don't really need to acquire anything sort of given the growth profile of the company. I'm just wondering what sort of your plan is on the balance sheet.

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

Yeah. Derik, I would like to talk about a couple aspects of that in use of cash. Number one is, as you know, we're going to continue to fill the high-valued product portfolio with internal organic investments. But in addition to that is continuously looking at potential bolt-on technologies or broaden the product portfolio. And I would argue in the last two and a half years of my tenure here, we've been not very acquisitive in that space. But I think we have a good position, we have good line of sight where our customers are asking us to look at for us to broaden the portfolio, and we'll take that under consideration as we move forward.

But we obviously are doing the dividends. We are doing a share buyback this year as the board authorized about 800,000 shares really to keep the share count somewhat neutral for the balance of the year. So, that's generally how we will look at use of cash today. And we are looking at that on a regular basis. We don't say that's static. If dynamics do change and there's more opportunities in one lever or the other to make sure we balance it between our customers and our shareholders, we'll do that.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Great. And some one final thing, I just noticed on slide 4, you called out some reclassifications of some sales in your Pharma segment. Can you sort of talk about what that is? And I think you had the sort of the impact of maybe making the 2Q comp a little bit tougher.

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

A

It doesn't have anything to do with 2Q comp, but it is, as you suggest, Derik, we've looked at the way that we record those sales by the market units, and there needs to be tweaking from time to time based on customers' order, things in the Biologics space, the Pharma space and the Generics space. So, it is difficult to parse it out between the various market units. We have gone through and we periodically go through and look at it. These are very, very small changes. They are not significant. In fact, for the full year, it's less than 1 percentage point. So, we just want to be absolutely transparent but...

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Yeah.

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

A

...really that was very, very small.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

So, it's just a matter of just like how your customers are sort of being defined or what it is, it's just that – I mean in that sense, started looking at it.

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

A

Yeah. It's just how – not how we define them. So, if you have a customer that we sell both Bio, Pharma and Generics, all three of them, into which we do have customers that are that way, parsing it out between those three buckets is not a perfect science. And we look at it periodically to make sure that we're getting it right. And again, just to reiterate, there is no change in the overall portfolio of Proprietary Products. None of these changes are outside of that, it's all within those three buckets.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Great. Thank you.

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

A

Thank you, Derik.

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

A

Thank you, Derik.

Operator: Thank you. And I'm showing no further questions in the queue at this time. So, now it is my pleasure to hand the conference back over Mr. Quintin Lai, Vice President of Investor Relations, for some closing comments and remarks. Sir?

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

Thanks, Brian. And thank you everyone, for joining us on today's conference call. An online archive of the broadcast will be available on our website in the Investors section. Additionally, you may access a telephone replay through Thursday, May 3, by dialing the numbers and conference ID provided at the end of today's earnings release. This concludes today's call. Have a nice day.

Operator: Ladies and gentlemen, thank you for your participation on today's conference. This does conclude our program, and we can all disconnect. Everybody, have a wonderful day.