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West Pharmaceutical Services, Inc. (WST)

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CORPORATE PARTICIPANTS

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

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

OTHER PARTICIPANTS

Tim C. Evans
Analyst, Wells Fargo Securities LLC

MANAGEMENT DISCUSSION SECTION

Tim C. Evans
Analyst, Wells Fargo Securities LLC

All right. I think we can get started. I'm Tim Evans, the life science tools and services analyst at Wells Fargo. We're very happy to have West Pharma Services with us and on the dais with me here is Eric Green, the relatively new CEO, and Bill Federici, who has been CFO for a long time. Gentlemen, thank you for being here today.

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

Thank you. Tim.

QUESTION AND ANSWER SECTION

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Eric, when you came onboard, you helped implement a market-led strategy for the company, and this is something that happened at Sigma-Aldrich, your former employer before it was sold, and I'm not sure if the investor community fully appreciates the impact or the importance of that strategy. Can you talk about what it means to have a market-led approach and how significant of a change is this to West?

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

A

Great. Thank you, Tim. And, first of all, I just want to say thank for the invitation to the Wells Fargo Healthcare Conference. It's been a very productive day and I appreciate being here. Absolutely, when I joined West, we looked at the organization and the strategy of the company and 90 years of success. And as we want to move forward with the opportunities in the marketplace, we did a deep dive into our customers and segmenting our customers based on their market needs and their expectations of us as a key contributor to their success.

So what we identified is that we had four distinct groups that we are currently servicing at West, and that's the Biologics, the Generics, the Pharma, and Contract Manufacturing. The market-led approach is more than just saying that we're going to become more customer-centric. It's really aligning the organization, so we took the entire commercial organization and moved it from a site or region specific to more global capturing around the segments. And what that has enabled us to do is to get deeper into understanding the value propositions for each segment.

Let me give you an example. In the Biologics, you could look at the large biotech players on a global basis, but what's also emerging is the biosimilar marketplace. In addition to that is the innovation pipeline that's coming out of the emerging biotechs, and those are sub-segments within the Biologics that we're focused on, which is driving our innovation and technology teams on new innovations and projects. It's also driving our operations and how do we more effectively service those customers because they have a lot different needs than Biologics, the Generics and the Pharma.

So I would argue that the market-led strategy, we changed the organization beginning of the year, has stabilized, I do believe the insights that we're gaining at this point and understand deeper of the markets and the opportunities for West is allowing us to make better decisions on our capital investments, whether it's on infrastructure or on innovation or even on more sales and commercial engine within those segments. So, it's been a good transition. We're well into it. I believe the organization has stabilized and the impact on customers I think has been favorable at this point.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

To the point about Biologics versus Generics, can you give us a very tangible example, for instance, of an offering that is popular with your Biologics customers that helps to meet their need there? Because I'm not sure that everybody totally understands the breadth of your offering. So really kind of give us something to hold on to that we can imagine and envision that, that really helps those customers with those products.

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

A

Right. Let me give you two elements of the Biologics space. One is, when you look at standard packaging, which West has been producing over 90 years, we produce about 32 billion components a year that are used in primary containment of injectable medicines. In the Biologics space, the interaction of Biologic into standard packaging versus elastomers or rubber, there's a reaction that could impact the effectiveness of the drug when it's administered.

So we have developed with our partners in Japan, Daikyo, which is a very long 40-plus year relationship of technologies and capabilities to put, for example, FluroTec coating on an enclosure, in addition to that to be able to Westar or washing of the product, so we reduced the particulate level sterilization into Envision inspection and into the [ph] bagging (4:40) that is ultimately delivered to the fill-finish location.

All those aspects of the process and the engineering and the manufacturing controls are within our high-value product portfolio. To give you two dimensions a bit, in the high-value product portfolio was $450 million last year. And it has roughly – when you look at that double-digit growth in our business, it's really being driven by the Biologics. It's to the point where the Biologic customers are only looking at the high-value product portfolio as a solution for primary containment. We want to go further than that. We want to be more than just a primary containment, we're now involved with delivery devices and that – as example, the recent launch of our SmartDose and CZ container.

So we're able to take a Biologic, put into a CZ cartridge and leverage a delivery device like SmartDose, which can be administered with a patient after resonance over a short period of time at the convenience of their home, which will drive down healthcare costs, but improve the uptake by customers taking the drug. So we're seeing – that's a specific example about the Biologic market where we're designing products that are intended to be effective and working with large molecules.

And the Generic is another example where Generic customers, it's a little different situation, that is about speed to market. And one of the examples I'll give you is when a customer is looking at taking a small molecule and commercialize, they can simply take the primary packaging that's currently being used on a branded pharma, it could be a standard packaging item, which would mean that they themselves have to scale up and to do the washing and to do the other services to really reduce the particulate level. Because of that, they're finding themselves actually creating more particulates in the process. Therefore, looking to us, and that's why you're seeing additional surge with high-value products because the Generic customers are looking to us to be able to help them scale in a very quick fashion, so they can commercialize drug in the marketplace. Those are two examples of the segmentation really driving our behaviors and better services or products to our customers.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Is there an easy way for us to think about how far along we are in terms of the penetration curve for high-value products?

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

A

Yeah. A great way to look at high-value products, as I mentioned, is about $450 million last year. But when you look at the 32 billion components we've manufactured every year with elastomers and seals, roughly 15% of the units produced are high-value products. So, we believe, and you look at our business today, 50% of our business are Biologics and Generic customers. When you look at the growth rates of those customer segments in the markets are high single to low double-digits, therefore, when we look at the runway we have with high-value products and the current penetration and future expectations is very attractive.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Got it. You talked a little bit about SmartDose and CZ. I think those products do get a lot of attention because they seem to lend themselves to a lot of press releases, but help us characterize the relative importance of those to West's overall business right now?

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

A

Right. When we look at the core business today, it is around the elastomer and seals business. It's roughly – that's 80% of our business or actually about 75% of our business, another 20% is Contract Manufacturing, and the balance is really the proprietary devices like SmartDose and CZ. And what we see is, these are future innovations that we're driving that will gain traction years out versus more short term.

We do believe it's part of our strategy because the fact that you look at connectivity of the primary containment, which we're very strong at with the elastomers and seal, all the way to the delivery of the drug, is the spectrum that we are focused to play and it's a larger marketplace for us to focus on. So, short term, while we're seeing strong growth in these areas, it's a dimension in CZ and SmartDose of roughly $30 million last year. We expect strong growth going forward. We've had a recent announcement with one customer of a combination device using CZ and SmartDose in their once-a-month delivery of their drug. So we're starting to see traction, we're seeing communication with customers, more interest, but again, this is more long-term focus as far as results.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

You talk about your pipeline of opportunities there and you gave us a number of the drugs that you're working on that are in development, but we don't know what those drugs are. And so, it's hard I think for us and for others to get a feel for what the potential addressable market for those products are? Can you speak about that in any way?

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

A

When you look at CZ, Crystal Zenith as an example, it is a substitution of glass insofar we are creating a new market opportunity, especially in the Biologics space. So when the Biologics is having – the customer is having difficulty containing the Biologic in a glass format, CZ is an alternative, such as cold storage requirements, negative 70 degree Celsius or 80 degree Celsius, glass may have more difficulties than Crystal Zenith, or CZ. And therefore there is opportunities.

To mention its size, as the Biologic continues, markets continue to grow and the needs of alternative glass like CZ and delivery devices like SmartDose will give us the chance to grow that. At this point, it's really early stages and although we do believe there is good growth three to five-plus years out.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Okay. Maybe one for Bill. The growth in high-value products has created quite a mix shift, because they are meaningfully higher margin offerings. And you've laid out a 2020 margin – operating margin goal of 19% to 23%, which is 400 basis points to 800 basis points above your implied 2016 guidance, and I think the Street is modeling a relatively even pacing of margin expansion over the next four years. Is that the right way to think about it or could it end up being more front-end or back-end loaded?

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

A

Sure. Thanks, Tim. And, first of all, we're not going to update guidance here for you, but when we talked about those numbers, end of last October, we'll update again at the end of this October. The way to think about the margin expansion is exactly what you said. So we have in the near term more of an organic growth coming from the mix shift scenario.

So, as we believe, we'll see more and more new molecules coming in that are more and more as a percentage basis of Biologic nature, that are going to be naturally addressed with the primary components being high-value products. But we're also going to continue to see, like in the Generic space, a migration from the standard product to the high-value product.

So when we put all of that together, we are thinking somewhere around the order of magnitude 50 basis points to 70 basis points of margin expansion on an annual basis on average in the near term. Eric described a scenario earlier where we start to gain traction from the commercialization of these integrated delivery devices, utilizing technologies like CZ and SmartDose, and as they become more and more important years out, then you start to see a little bit of a different margin expansion, kind of an inflection point in there.

The difficulty for us as well as for you, Tim, is to describe when that happens. We don't control the timing of the customers working with us, we can provide them with the products, the CZ products or other of our devices, but they are the ones that are doing the testing, the clinical testing, the filings and answering your regulatory agencies questions, and then developing the product for a commercial launch.

So the timing is something we don't control. So it's very difficult for us to put a stake in the ground exactly when that inflection point happens. We know it's somewhere not in the next few years, but we do believe that once we get past that inflection point, you'll start to see a higher growth of margin expansion beyond that 50 basis points to 70 basis points that we believe will happen over the next few years.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Is the inflection point you talked about specifically on CZ and SmartDose or is it broader set of high-value products?

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

A

It's somewhat broader. You have CZ and SmartDose, of course, those are the ones that we always talk about, but some of the products that we have on the component side of the business as well that are newer technologies that we believe will also give us the ability to continue to expand margins, such as the recent launch of NovaPure, which is a great offering for our customers, especially in the Biologics arena, we're looking for a mentality of zero defects where you get the highest quality possible product.

To help them in that regard, we created NovaPure, which is a quality by design product that we believe will help them on that journey towards zero defects. We believe that kind of a margin associated with that product will be very nice margin and will help us in addition to CZ and SmartDose expand margins beyond that 50 basis points to 70 basis points.

But just one more comment on that, NovaPure, as a category, is less than $10 million of our sales today. So it's still a very small nascent part of our business, but we believe we'll continue to grow as we go.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

I think it's probably fair to say, going back a number of years that CZ has taken longer than maybe you expected to inflect. So what gives you the confidence that that will happen in the reasonably foreseeable future?

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

A

When you think about CZ in a more recent, in the last 12 months, we've had a situation where we had at least two commercial launches in vial formats and a third of that is in a cartridge. And so, we also take a look at the pipeline of number of molecules that are being tested on CZ and worked and looked at, at this point is over 100 that customers are currently exploring. So, there's an increase on interest, especially after the announcement of a couple of drugs now on the CZ format. But we continue to be cautious on how we look at the outlook, but the reaction from customers is very positive for all the attributes that we mentioned before.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Okay. Let's turn to the contract manufacturing segment, maybe this one doesn't get quite as much of the attention as the high-value products, but it is something where there's a little bit of noise in your gross margins. Can you talk about what's going on there and what's going on with the guidance in the gross margin line for that business?

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

A

So certainly, for contract manufacturing, we don't own the intellectual property. So it is a business that doesn't have the same – generate the same kind of margins that we generate on the proprietary protected part of our business. That said, it's a very important part of our business and will continue to be so going forward. When we look at contract manufacturing, there's really a couple of different buckets within contract manufacturing.

One, that's been somewhat of a laggard compared to our normal growth trajectory, which we've said will be in around the mid single-digit growth. That growth has been a little bit less than that in the consumer products part of that business. So when you think about contract manufacturing, it totals about $300 million of sales. About $70 million of that is in the consumer products space.

So we manufacture things like the nurser nipple assembly for our customer. We manufacture some other products on the consumer side. And the demand has been a little bit less than what we had normally expected at that 5% range. In the second quarter, we saw growth coming back, but not quite to where we expect it to be, but over the rest of the year, we believe contract manufacturing as a whole will be in that 5% range.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Okay. There's been some controversy around drug pricing. Obviously, it's a big topic right now and particularly on injectable devices, that one has popped up in the media a little bit. And I understand that you don't talk about specific customers, but can you comment in general about how drug pricing affects your business?

Eric Mark Green

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

A

Yes, I just wanted to mentioned, when we look at pricing at West, first of all, the part that you're speaking of, EpiPens, we are – in our contract manufacturing business, again, just reiterates about 20% of our business today, margins in that business, which is just shy of 20% and we do manufacture some of the components for products like EpiPen.

We're obviously involved with the insulin pens and continuous glucose monitoring systems. So when you look at our business today, our pricing on a global basis historically has been roughly around 1% increase per annum and that's where we are today. We market our products based on customer demand, obviously looking at the value proposition, if you take a look at the standard packaging versus the high-value products, portfolio is positioned differently because of the attributes and the benefits that are being delivered to our customers. So when you look at the mix as a whole, it's about 1% and we're not directly tied to a end market price of our customers. Our business really is driven based on units and volume and not as so much on the price component to the end drug in the marketplace.

Tim C. Evans

Analyst, Wells Fargo Securities LLC

Q

Do you – historically speaking, within a historical precedent, do you find that when the price of a drug declined, say, for instance, the drug goes generic or something like that, that the customer comes back to you and asks for concessions or something like that?

Eric Mark Green

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

A

Yes, I think it's also important to note, that's a very good question, Tim, but when you look at the cost of our components in the drug is very small, and in fact, it's a very low number. So therefore, they're looking at us as how do we – total cost of ownership approach, as we talk about bringing – as it goes into generic format, for example, we're [ph] fighting (20:18) in the biologics in the generic space for us our customers, relatively consistent profitability for West.

Again, it's because we are driving more of the high-value products, we're doing more of the services for them, taking costs out of their own system and we're able to capture that in our own business. So I won't state that as moving from a brand to a generic situation that we see a lot of difference in economics, it's all back to the units and the volume component.

Tim C. Evans

Analyst, Wells Fargo Securities LLC

Q

Got it. Let me go back over to Bill for a second. Your CapEx spending has been fairly elevated since about 2012, stepping up again in 2016. And what you've said in the past, I think you said it's likely to just kind of stay at 2016 levels for a few years. Some investors are concerned that your business model is one that will always be very capital-intensive and free cash flow might not be what you would expect from a less capital-intensive business. Is that the right way to look at it or does some of this normalize when you look out past five years?

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

A

Sure. And yes, it has been somewhat elevated. We've talked about Waterford, Ireland being a special situation where this year alone, we'll put $60 million of capital into our facility in Waterford, Ireland, and probably a similar amount next year. But yes, when we look at capital and we think about capital allocation, we believe in and we think that we have the history to state that the best use of our capital dollars is to put money back into the core of this business that is continuing to be fueled by demand, increasing demand from our customers for our very, very high value products.

So things like washing capacity for Westar, things like new vision systems for our Envision product and things like clean rooms for bagging in a clean environment to reduce particulate loads, which are all very, very important to our customers on their journey towards zero defect. So the level of capital is a little bit of a hybrid, right. We have some maintenance capital in there, some IT capital and then there's growth capital including Waterford.

So for the next few years, I do agree with you, it's kind of in that range of $150 million to $175 million. What we see is, as a percentage of sales, as the business continues to grow due to the factors that Eric's talked about, the migration towards high value products and these increased new biologics coming into – to the commercial realm, we're going to see increasing operating cash flows, a similar amount of, from a raw dollar perspective, of CapEx. And therefore, from a free cash flow perspective, we will see increasing amounts of free cash flow developed by this business.

But again, we do – it will fluctuate over time, the amount of CapEx on a raw dollar basis, but as a percentage of sales, that CapEx will continue to come down. We believe we'll be in the high single digits by the end of our planning period.

Tim C. Evans
Analyst, Wells Fargo Securities LLC

Q

Got it. Before I go on, are there any other questions in the room? I see none. Let me – let's talk a little bit about your capital allocation priorities. So, obviously, CapEx is the number one priority that you've laid out. And you've also said that your dividend is important. But beyond that, you've talked a little bit about inorganic investments. West is kind of a differentiated business, there's not a lot of things that are obvious strategic fits for you guys. So what kind of tuck-ins do you think would make sense and where do you maybe see your business going in that direction?

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

A

Right, and that's a pretty good question. So as we look at our innovation and technology strategy, about half of the effort of the team is looking at how to expand existing portfolio. So product line expansion, new formulation, elastomer business, [ph] the seal (24:24) business and we're also looking at – the other half is looking at how do we drive more into the delivery devices. And it's beyond just talked about the SmartDose, but can we get involved with NanoPass as an example, which is an equity stake we took just recently.

And so our focus really is, in the delivery device realm, what is unique niche opportunities that are unique for the biologic marketplace that could leverage the primary containment that we really – that's our core competency as a company, understand the interaction of the materials and the drug as you move into the delivery devices. And so, that's an area of focus of bolt-on technologies that we're looking at today and [ph] creating (25:13) an engine of constant reviewing and assessing whether it's an equity play or a small acquisition.

Anything larger is really staying true to the space that we've talked about is from – all the way from primary containment all the way to delivery devices, there is different aspects of that and we're continuously evaluating if a larger opportunity did present itself, how would it strategically fit and better service our customers?

Tim, you're right. The growth story of West, to be growing, we say about 6% to 8% historically on the organic [ph] side (25:48) of the business and actual margin expansion moving up to the high value price, is a very compelling story. But we're also looking how do you see the future growth more long-term with these tuck-in opportunities and potentially strategic plays. Our balance sheet is strong. Our net debt is very low and I think the organization is aligned today, is really moving forward nicely. And so, I think we have opportunities to look outside.

Tim C. Evans
Analyst, Wells Fargo Securities LLC
Q

Let me just drill down a little bit on like that idea of more devices. SmartDose effectively functions as a device, right, and this is kind of a different area because historically you have an enormous market share in your elastomer market, in your high-value market. In devices, it's a more nascent market and there are potentially more competitors there. What can you do to work on developing a similar kind of moat that you have in your elastomer business, in that device business?

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

Well, I think the recent example of SmartDose is a good example, it's a combination device of that particular product with another drug, a biologic, and truly staying true to differentiation of a biologic drug, use it leveraging the primary containment capabilities that we have at West, the know-how with the delivery device. And what's really unique, when you start looking at our contract manufacturing business, the engineering, the designing, the mass manufacturing capabilities of plastic components is definitely a core competency of that business.

And so, [ph] we (27:31) start leveraging that capability along with new novel technologies gives us the right to play when it comes into delivery devices. The delivery device need to be – it has to be tied to the primary container, that's where we have the differentiation. We got regulatory barrier, the filing with our customers as a combination device, this is a clear focal area that we have for that part of the business.

Tim C. Evans
Analyst, Wells Fargo Securities LLC
Q

Would you care to remind us the pipeline of opportunities that you have there? You characterize like a hundred customers kind of evaluating CZ, but maybe you can [ph] hone in (28:05) a little bit more on this?

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

Sure. So it is, when we talk about formal stability testing, which is one of the last steps they do before, so customers are very serious at that point. You take that hundreds or more than 100 compounds that are currently being tested using CZ today, a subset of that are actually in formal stability. It's a little hard for us to pin an actual number.

It's somewhere between 12 and 15 based on the data that we get from our customers, which obviously they don't tell us all the things we need to know, but there are at least that number that we know of. And those are, again, very serious once you get into formal stability testing, the customer is spending a lot of money and spending a lot of time developing their drug component in that particular container, as Eric said.

So that's a way to dimension it. So, hundreds are looking at it, somewhere between 12 and 14 are in, what we would call, formal stability, which is a very serious later-stage view of CZ. On SmartDose, we talked about the one product that had been approved.

There are, what we call, development agreements, there are seven of those with customers. A development agreement could be anything from us working with the customer to help identify whether the drug and the packaging are compatible to the size of the package, the attributes of the package, what kind of features it would need, those kinds of things. So those are all done in a development environment and there are seven of those that are currently ongoing.

Tim C. Evans

Analyst, Wells Fargo Securities LLC

Q

With the last few seconds here, how should we think about opportunities that you might have on the tax line?

William J. Federici

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

A

We certainly have done what we can to effectively utilize our global infrastructure. We know that our tax rate is relatively high, but we are first and foremost manufacturing in locations where we believe it makes the most sense for our customers and the need is there and the demand is there.

A natural adjunct of the high-value product portfolio and the work we're doing in Waterford will be we're setting up centers of excellence for manufacturing where we believe we'll be finishing at a very, very high quality level, the highest quality level, in places like Ireland, where it's the right thing to do because we'll be producing very, very high quality product on a consistent basis for our customers where the demand is, but an ancillary benefit of that will be in the future is that their tax rate happens to be lower than what it is elsewhere around the world.

So, we believe that the most important thing that we're doing is addressing customers' needs and demands for higher quality product. We believe centers of excellence for those kinds of productive capacity make a lot of sense and we're doing that. And we have developed one where we're putting that kind of productive capacity into Ireland where the tax rate will be an ancillary benefit to that.

Tim C. Evans

Analyst, Wells Fargo Securities LLC

Great. We'll wrap it there. Thank you, gentlemen.

Eric Mark Green

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

Thank you, Tim.

William J. Federici

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

Thank you.