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West Pharmaceutical Services, Inc. (WST)

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CORPORATE PARTICIPANTS

John Sweeney
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OTHER PARTICIPANTS

Dan Leonard
Analyst, UBS Securities LLC

MANAGEMENT DISCUSSION SECTION

Dan Leonard
Analyst, UBS Securities LLC

Green light. Well, thank you all for joining us for this session at the UBS Global Healthcare Conference. I'm Dan Leonard. I cover life science tools, services, and diagnostics for UBS. We're pleased to welcome West Pharmaceutical Services and representing West is Eric Green, CEO; and John Sweeney with Investor Relations. Welcome, both of you.

John Sweeney
Vice President-Investor Relations, West Pharmaceutical Services, Inc.

Thanks, Dan.

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

Thanks, Dan. Appreciate you having us.

QUESTION AND ANSWER SECTION

Dan Leonard
Analyst, UBS Securities LLC

Q

So a lot of ground to cover today. And since you're fresh off your third quarter results, I figured, we'd start there. Can you share with us the key highlights from your Q3 results as you saw them?

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

A

Yeah. Well, first of all, Dan, thanks for having us. Beautiful venue, a little bit different than Philadelphia.

So the Q3 results, very pleased on how the team drove execution for the quarter. We set guidance for the second half of the year at the prior call, and I'm pleased that we delivered on our commitments throughout the quarter and feel comfortable – continue with that throughout the balance of the year.

If we think about some of the key trends that we're seeing in our business, and we're very confident about long term, it really is continuing to be the biologics growth and our participation rate in new launches and supporting our customers on those launches. It's also working with our customers as they do work through destocking. And we can talk a little bit later about the different segments where they are on those journeys.

It is also about launching – supporting our customers on large launches around GLP-1s. We participate in our elastomer business, quite in a very significant way, but also in our contract manufacturing. And it was also supporting our customers on new projects around Annex 1, which is the European regulation change that's occurring, and we're engaged heavily on those projects and excited about the future.

And last but not least, but we had significant ramp-up of a new site in Phoenix with our – one of our wearables SmartDose to build, support a customer on their launch of important drug molecule in the market with already a captive patient population. And that site was commissioned in Q3, and we're very pleased that they are meeting and exceeding expectations on the ramp-up as we speak, but that will continue over several quarters. So there's a lot of highlights about the quarter, some tailwinds, some headwinds, but pleased with the results.

Dan Leonard
Analyst, UBS Securities LLC

Q

Okay. Well, I feel like you front ran my LRP question with some of those items you kicked off, and we're going to circle back to that towards the end.

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

A

Okay.

Dan Leonard
Analyst, UBS Securities LLC

Q

So maybe I'll take a couple of the non-LRP-related topics that you just mentioned there, one of which is the ramp in Phoenix. I just want to confirm, I think I heard you correctly there, that it was one customer you're supporting there.

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

Correct.

Dan Leonard
Analyst, UBS Securities LLC
Q

And my broader question was I'm curious how broad or narrow is the growth from SmartDose?

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

Yeah, that's a great question. Now we have three products. It's a combination device approved with three different molecules. This particular one, which is quite exciting, is allowing patients to move from an infusion or IV infusion setting to a subcu. So, it is a customer that we're working with and we're ramping up. As I said, that they currently do have a patient population that they're serving. So it was a matter of just getting capacity built that we can ramp up and build support them on the demand.

The capacity that we put into Phoenix, which is an existing site that we have, but we repurposed it particularly for wearable manufacturing. It basically doubles our capacity between – from Scottsdale. So between Scottsdale to Phoenix, we have 2x the volume. And we're excited that – and it's still a semi-manual process, and we have invested in a fully automated line that will be in our facility in Phoenix early 2025 with the intent to have ramp up for commercialization towards the end of the year. Obviously, through various regulatory and quality checks jointly with our customer. So, we're excited with – be able to support our customer, but we do have three products in the market, but this clearly will be the largest that we have to date.

Dan Leonard
Analyst, UBS Securities LLC
Q

And what does the funnel look like for this product? Is it three going to 30? Is it three going to 10? Like how wide or narrow is that funnel?

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

Yeah. So I'll just – the way I'll articulate is we have two platforms. One is the smaller versions, 3.5 ml and then also the 10 ml. And we have development agreements in place for customers that will use both platforms. And I won't quantify that at this point.

Dan Leonard
Analyst, UBS Securities LLC
Q

Sure.

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

We'll talk about it once we have commercial approval. But when we get – what's exciting about the latest one, it is this whole concept to be able to support patients, improve patient outcome and patient adherence going from an IV to subcu.

So, you can imagine going into scheduling time, go into a clinic or a hospital setting to get the infusion, whether it's your first week, your fourth week, your eighth week, and then able to have more of a booster or maintenance every eight weeks afterwards by using the subcu wearable. It really frees up the patients – improves the patient's experience and you can start thinking about driving costs out of the healthcare and better patient outcome. So the technology is proving what it was intended to do is allow more flexibility and drug delivery to patients.

The certain criteria that this will be targeted, obviously, larger volumes. Obviously, if it's lower volumes, you could use auto-injectors or prefilled syringes or even vials. When we started thinking about high viscous molecules, therefore, is more time to actually deliver through subcu. Those tend to be the categories and not just in product and development stage through clinical and industrialization, but you start thinking about products in market already that has a patient population. You can change the way it's delivered to the patient to make it a better outcome. That's the other avenue we're seeing traction as we speak.

Dan Leonard
Analyst, UBS Securities LLC

Q

Okay. And the comment you made about automation...

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

A

Yes.

Dan Leonard
Analyst, UBS Securities LLC

Q

...coming in 2025, what are the implications in terms of narrowing the margin gap on this product category...

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

A

Yeah.

Dan Leonard
Analyst, UBS Securities LLC

Q

...for you compared to the balance of the business?

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

A

Yeah. We called out the margin and we want to be very clear that our expectations of the margin of this portfolio is far greater than what we currently have. And there's really three drivers for that.

One of them is driving more automation. You can imagine if you're producing product and it's a highly manual process, go into a fully automated process with no human interaction other than engineers to support the line, it's a tremendous accomplishment in throughput, yield, quality and that will be obviously a driver for margin expansion.

Another is we're starting to get scale. When you start to get scale, you're able to drive more lean practices in these facilities, which we didn't have before. We had the principles, but when you have scale, it's harder to get that leverage.

And the third is, they continue to make sure that we are creating the value for our customers and their patients, so we can capture more of that. And that's also ongoing as we speak.

Dan Leonard
Analyst, UBS Securities LLC

Q

Okay. All right. Another consistent topic for West in – of the broader bioprocessing industry, drug packaging industry, et cetera, has been the destocking phenomenon...

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

A

Yeah.

Dan Leonard
Analyst, UBS Securities LLC

Q

...we've seen over a couple of years now. Just bring me up to speed on where we are across the different customer types that you serve?

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

A

Yeah, absolutely. So if we just put it in context, I think West is in a little different position than others in the industry. And why I say that is during the COVID period, we were allocating resources or assets or manufacturing capability to support the vaccines in addition to existing customers. And therefore, when you start thinking about allocation and prioritization, our lead times increased from – anywhere from 10 to 12 weeks up to 40 to 50 weeks for a period of time. That caused this effect of customers building the inventories and building stock, and that was pretty much a consistent phenomenon across the whole pharmaceutical supply chain.

And as COVID started to decline, the demand of the vaccines and the layered in capital we brought in, we're able to improve – increase capacity and drive lead times down to, right now, they're 8 to 12 weeks, which we believe is equivalent to what we have pre-COVID if not a little bit better. And we'll continue to drive improvements in that area.

What has that resulted? That's resulted with a higher degree of confidence customers or more consistently as they have done in the past. But it's different in different segments. So if we think about the three segments we look at, biologics and biosimilars is one, generics is two, and third one is a small molecule – innovative small molecule, we call pharma.

The pharma destocking started earlier, less dependency on the high-value product manufacturing, which is what was used for the vaccines. We see that has – we believe that has more normalized recently than when it started over a year ago. So, we see pharma coming back into more normalized levels as we speak. And just to remind everybody, we see that segment about low single to mid-single-digit type growth overall.

The generics, which is – if you look at our portfolio with generics, about 60% of the business is high-value products. Therefore, some reliance on the high-value product facilities. That destocking has been later, and we believe that's going to continue, as we mentioned in our last call, into 2025 or the first half of 2025. There's less number of customers, but larger volumes of drug molecule in market causing this effect.

And the third area around biologics. We've been seeing that destocking ramping down in – throughout 2024 and to the end of this year. We believe that will be becoming more normalized as we go in – throughout 2025. So, it's not a consistent message across all three segments, but we have – I believe we have better visibility than we had before on what's happening on the destocking element today.

Dan Leonard
Analyst, UBS Securities LLC

Q

And how would you characterize the performance in Q3 in high-value components, specifically as it relates to destocking. How would you characterize that versus your expectations? Because at least from where I sat, I couldn't tell if things were incrementally better or not.

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

A

Yeah.

Dan Leonard
Analyst, UBS Securities LLC

Q

I mean the high-value components still declined at a double-digit clip, but some of that's seasonal. So I don't know from your vantage how that landed.

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

A

Yeah. No, that's a good question, Dan. So when you think about high-value products, majority if not – majority of the biologic revenue is high-value products. So well north of 90%, in the generics is roughly around 60%. And so the destocking effect is still quite common or happening through those two segments. And therefore, it's a direct impact on high-value products.

And you can see that in our margin profile. Biologic, biosimilars is the most profitable segment directionally than generics, followed by pharma/small molecules. So when you have that high-value products in your portfolio, you have better economics, and that's what's happening when you look at the Q3 results, is that it was in line with our expectations, because we knew the pacing of the destocking.

But when we get back to more normalized volumes and growth rates of these three sections, as I mentioned earlier, pharma low to mid-single digit, generics mid to high single-digit growth, and then biologics double-digit growth, that's the long-term algorithm that we see, we've experienced for the last five or six years without COVID, if you strip that out, we believe that's the case going forward.

You get to those more normalized levels, you will start seeing that high-value product, again, the category be double-digit growth and you'll see us go back to more of the normalized margin profile, the operating margin closer to the 2023 level. And as we go forward with that growth of HVP, we'll get back to that cadence of 100 basis point margin expansion of the operating margin.

Dan Leonard
Analyst, UBS Securities LLC

Q

Okay. Understood. And then maybe final question...

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

A

Yeah.

Dan Leonard
Analyst, UBS Securities LLC

Q

...here on destocking and I'll move on. But it does seem like – you mentioned before that your experience is different than other experiences in the supply chain, everybody touches the customer a little bit differently. But one of the things that's a bit of a challenge from my seat is it feels like different companies are reporting destocking is an incrementally worsening issue at different points in time.

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

A

Yeah.

Dan Leonard
Analyst, UBS Securities LLC

Q

And in the most recent quarter, it was Gerresheimer. So I don't know if it's possible to educate on how maybe the demand drivers for your specific product portfolio or destocking could be different than glass packaging or other areas of the supply chain?

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

A

Yeah. I think by looking at just the elastomer space, there's really three players in that market. I think that's probably a better lens than looking at adjacency of components, because the – there's different elements that go into play.

For example, when you think about elastomers, majority, not all, but majority of our elastomers have a shelf life of two years. And that's not consistent as you think about different components used in the pharmaceutical supply chain. So therefore, a destocking effect not only has a volume effect, but also a time bound, and that's one element.

The other element is that our dependency around biologics and generics has really increased. As you think about our participation rate in biologics, it's greater than 90%, and that's consistent to what's going on in the first three quarters of this year and in prior quarters.

So West continues to have a very strong position in [indiscernible] (00:14:55). And also, as we start thinking about the growth drivers and now it's become the largest segment of the three, it has a, let's call it, a smoothing effect of our performance. So, I would – while there's some similarities, there's clearly some differences between the different businesses as we think about how we support the industry.

Dan Leonard
Analyst, UBS Securities LLC

Q

Understood. So shelf life and then the biologics relevance for West specifically.

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

Correct.

Dan Leonard
Analyst, UBS Securities LLC
Q

Understood. That's helpful. All right. Moving on to those three different customer segments you talked about, are there any pharma, biologics and generics? Are there any differences in visibility you have into demand trends, one customer segment versus the other?

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

Well, I would say it's not really that segments by customer.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay.

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

It's very unique. Each one is very different. They have different criteria that they're looking for safety stocks, what they're looking at lead times. The types of products they are procuring from us, the frequency of these orders, they're very, very different.

I mean we talked a little bit about the destocking trends in general by segment that tends to be segmented accordingly. But when we start thinking about how various companies are doing their inventory management, there's a lot of differences from customer to customer. So it's really keeping our teams really close and engaged with not just the manufacturing and the quality side of the organization, but in the procurement and also the supply chain is very important for us.

And also getting better visibility of that just what's in inventory for future – fulfillment of future demand with our customer, but what's in their channel. And by having that lens, we'll have better visibility going forward to support. It's not perfect. We'll continuously put programs in place to get closer with that information. But there – it's difficult to say as general by segment.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay. And I don't think you report order book, but could you speak at a high level on some of the leading indicators that you're seeing in your business, which gives you confidence in the future?

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

Yeah. We feel good about our order book. Nothing has changed from the last call for this quarter. And if we think about our type of order book, we tend to get 18 to 24 months of orders from our customers and it varies.

Again, if you look at percentage of orders from our customers, obviously, the first two quarters from today is a lot higher than six, seven quarters down the road. Every customer has a different way of placing orders with us.

So we have a forecasting mechanism that we forecast with each customer by molecule, what SKU matches up with that molecule. And then we then look at when firm orders come in. And those are the leading indicators of how we should perform from a delivery perspective over the next several quarters. And it helps us level load our operations. It helps us plan and schedule, because if you think about our business model, majority of our product is make-to-order. So that's why it's important for us to be able to schedule appropriately at plant level, so we can meet these demands.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay. That's a lot more complicated than my spreadsheet. I'll tell you that.

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

Okay. Good.

Dan Leonard
Analyst, UBS Securities LLC
Q

But probably necessary to run a business. What can you tell me about the pricing environment today? Where it's been? Where are you today? And where from a pricing power perspective, do you see the future?

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

Yeah. The history of West, we were operating more of industrial mindset, I think, call it, less than 1% or 1% to 2%. And then we did a pretty thorough review back in 2019 into 2020. And that has created an environment where our strategic pricing has been a little bit different. We're value-based. We don't have a list price.

So we are working with our customers to identify what type of regulatory quality services do we need to provide? So what it does, it drives a pricing mechanism that allocates the type of work and value we're going to create.

When I say that, we still do measure the traditional net price contribution. And we are – our belief is 2% to 3% is what you should expect from West and long term. I know last year was a little bit higher due to inflationary reasons. The year before was definitely – slightly higher than the 2% to 3%. And this year is probably in the upper end of that range, a little bit higher.

So we feel good to – we feel that we have a model that we were able to get 2% to 3% net price. This does not include mix, where we move the customer up in the value curve of the high-value products and capture more ASP and more margin, that does not included into net price contribution.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay. So that's an apples-to-apples analysis...

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

That's an apples-to-apples, yeah.

Dan Leonard
Analyst, UBS Securities LLC
Q

And then from a facility ramp perspective, we talked about Phoenix, you have other big manufacturing facilities, which are coming online and adding capacity in the near future. What ought to be front and center in our minds in terms of incrementally affecting the ramp of your business?

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

Yeah. No, that's good, Dan. There's probably three areas to look at. One, on the elastomer side, it's not new facilities, but it's new processes and equipment in existing facilities. So this is high-value product finishing.

So you think about pharmaceutical washing, sterilization, envision, inspection, and then a few other services that we provide. That is very important to drive biologics, GLP-1, and Annex 1. That's already – a lot of the investments have been made already, and we'll continue to make reasonable investments going forward.

The second area we talked about the Phoenix site around drug delivery devices, fortunately, that's completed. We're ramping up, but there's a lot of work to do to be able to meet demand as we go into 2025 and then get the automated line and enable us to increase capacity significantly so we can stay ahead of the curve and then bring additional customers in as we speak.

The third area is in our contract manufacturing area about – when you talk about major expansions, we built a dedicated facility in Grand Rapids, Michigan. It's a campus-like environment for – to be able to manufacture auto-injectors for GLP-1. That is in ramp-up stage as we are speaking. That will happen throughout 2025 and get into peak volumes towards the tail end of 2025. That will help our contract manufacturing business.

In addition to that, we have a new facility that has been built in Dublin, is being commissioned. It will take several months and throughout – about halfway throughout 2025 to get to a point where we can start doing commercial manufacturing. Again, that's auto-injectors for the GLP drug.

And in addition, in that facility, we are moving into drug handling, which is a service that we have provided in the past for smaller clinical trials. This is for an important customer, obviously, for that facility, the GLP-1s. So it will be a continuation to a final product at the end. By proving that concept, we're looking at, [ph] build and replicate (00:22:40) that in the US down the road.

So if you think about fast forward of that investment, it's an entry point and how to handle drug handling in other parts of our operations going forward.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay.

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

To be very clear, drug handling is not fill-finish. It is strictly the fill-finish final product and marrying it up to the device and then able to give it to the channel.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay. And is the elastomer that the first expansion you talked about across your elastomer business, is that specific to Kinston? Or is that across your different manufacturing sites?

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

It's Kinston, Waterford, Jersey Shore. Jersey Shore is currently going on. We should have that completed by middle to the end of 2025. Waterford is also in process. And then Kinston is just wrapping up. So they're at different phases. So the capital that we have laid out, obviously, initially it was around the COVID response. A lot of that's fungible – all of it's fungible to the products that we're talking about that support biologics, GLP-1, Annex 1, and we'll continue those investments in 2024, we believe some of that will be also in 2025.

Our goal, though, on CapEx, I know it's been higher than 10% to 12% the last few years, we do believe the – based on our model, based on the infrastructure we have in place, the equipment processes, we do believe more long term, we are able to get to 6% to 8% of capital CapEx as a percentage of sales to support a 7% to 9% organic growth – top line growth for West. If there's opportunities to grow faster organically, we will invest. So, it might go further a little bit higher than that. But to get to that 7% to 9%. 6% to 8% is the investment thesis we need to do to continue to maintain that growth.

Dan Leonard
Analyst, UBS Securities LLC
Q

And is that a 2025 ratio, or is that 2026...

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

That's a little bit longer than – we're not going to guide 2025, but we have some investments in flight right now. A lot of these investments take more than one year to conclude.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay.

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

So you have some of the costs going into 2025. But as you think shortly thereafter, we should be getting back to the 6% to 8%.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay. So 2026 and beyond would be...

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

Yeah.

Dan Leonard
Analyst, UBS Securities LLC
Q

...when it did.

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

To be closer to the 6% to 8%. I won't guide right now, but.

Dan Leonard
Analyst, UBS Securities LLC
Q

Sure.

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

Yeah.

Dan Leonard
Analyst, UBS Securities LLC
Q

From a framing perspective?

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

Yeah. Absolutely.

Dan Leonard
Analyst, UBS Securities LLC
Q

Understood. Well, that's a great segue into talking about some of the long-range plan drivers. You mentioned the 7% to 9% is the corridor that you aspire to.

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

Yes.

Dan Leonard
Analyst, UBS Securities LLC
Q

We've talked about biologics. I don't know if there's further comments to make. It sounds like your win rate or what do you call it, your involvement rate or...

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

We call it participation rate.

Dan Leonard
Analyst, UBS Securities LLC

Q

Participation rate.

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

A

Win rate is probably better, but it's not just the winning and being put on the molecule, but it's also to be able to plan the launch and participate [indiscernible] (00:25:50) in that launch. And once you're commercialized, it is about keeping up with the volume.

Dan Leonard
Analyst, UBS Securities LLC

Q

Does genericization of some of these blockbuster biologic drugs, does that influence your thinking at all? Does that matter for you or no?

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

A

We're excited about the biosimilars.

Dan Leonard
Analyst, UBS Securities LLC

Q

Okay.

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

A

We really are. And we actually categorize biosimilars with biologics. So I know typically, you may want to think it is generics. But for us, we categorize biologics and biosimilars, just because of the value proposition. The products we provide has the same characteristics as biologics, same economics for us.

And you're absolutely correct. The biosimilars, particularly the CDMOs are really a global phenomenon, right? And we're very well positioned. So when we talk about the win rate, participation rate of biologics, we're also inclusive of biosimilars.

Dan Leonard
Analyst, UBS Securities LLC

Q

Okay. And then how should we think about framing the Annex 1 revisions as you know, into your business opportunity? What's the unit opportunity incrementally for West Pharma?

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

A

So the way we look at it, just for those that may not be familiar with the European GMP Annex 1 regulation has been around for a long time. But what's been included or added to the regulations last year was the requirements around primary packaging, it's really a particulate level and quality expectations to be able to support the regulatory filings.

And what has changed there is that now the – like the elastomers and other components are now part of the equation. So typically, what you'd see is customers buying bulk elastomers, they would include in their process to the washing and remove the particulates. But what we're able to do is actually provide, they call it ready to use.

And so – what that means is that we're going from a bulk component where we could classify as standard. And the economics there could be $0.01 to $0.02, maybe $0.03 a unit. Margins are 25% to 30% margin.

Now we're going into high-value products because we're introducing our pharmaceutical washing, it could be sterilization, could be envision, inspection. Now you're getting into $0.10, $0.15, $0.20 a unit and now you're getting into margins that are 40%, 50%, 60%.

And if you look at – this is really around molecules finished product that's going into the European community. And so you can have companies that are exporting or importing into Europe. So those manufacturing locations outside of Europe are also in scope. That could be from Europe, it could be different parts of Asia and also the United States or North America.

And if you think about the 43 billion components we produced last year, roughly about – when we look at the scope and the opportunity, roughly around 6 billion of those components we would categorize in that situation where the standard bulk material that customers builds molecules could potentially driving towards a ready-to-use solution.

So if you think about our investment thesis we've been driving over the last couple of years, particularly this year and then finishing next year, those processes are around high-value product finishing. Going back to the pharmaceutical washing, sterilization, envision, inspection, that's where the investments are going to support the impact of Annex 1 on customers and those molecules.

The key thing here is that our customers are not looking to change the formula. So as you know from – about our business, the elastomers have unique formulas, it's IP to West. That's for our customers that they use to file and they really point towards the drug master file. That doesn't change. So there's not a whole new series of studies that have to be conducted for filing. But what it does do once we start introducing these other services and capabilities, those are the drug master files the customers will point to, it's more an amendment or a minor change.

Why is that important? Because our processes to start with don't change, which is very important. And these are existing molecules in the marketplace. The units don't necessarily change, but shifting from a unit perspective, shifting from standard to HVP.

Our HVP number of – percentage of units that we manufacture is only 25%, but it's 75% of revenue. To get double-digit growth, which is really biologics and some generics of HVP, it only takes 100 basis points year-over-year to get strong double-digit growth. And that's happening already with approvals of biologics and our success in generics.

With Annex 1, it's an additional catalyst over time to ensure that we're continuing the runway of the HVP journey out West. So hopefully, that gives you some insights on how we dimension this opportunity.

Dan Leonard
Analyst, UBS Securities LLC

Q

I'm still thinking about it. So the 6 billion units, that's specifically units that would be going into Europe?

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

Yes. These are units that would be on drug molecule being consumed in Europe, correct.

Dan Leonard
Analyst, UBS Securities LLC
Q

So is there an expectation in that framing that similar rigor wouldn't be adopted elsewhere in the globe. And like does it make sense for the customer to have a different process for shipping...

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

Yeah.

Dan Leonard
Analyst, UBS Securities LLC
Q

...something into Europe versus shipping something into New Jersey?

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

Yeah. So that's a very good point. And some of our customers are having that conversation where they don't want to have two standards. They would like to have one standard to use it globally. And we saw this actually phenomena happen particularly in China, when YBB is a regulation that was put in place years ago – a few years ago. Our customers wanted to make sure that not only the test protocols are meeting European regulations, but also YBB, because therefore their supply chain could be interchangeable. And so that's a phenomenon that could happen.

But on the other side, is that there's no – it's not – this regulation isn't as – the clarity of time bound is not there. So we have certain customers that are leading, they are moving forward. We had less than 100 projects last year that we started. It carries on throughout this year. It takes about 18 to 24 months to go through that journey. And we have about 200 projects this year. So, we're seeing the momentum pick up, and it will – and this will start turning into commercialized product for our customers. But to your point, there could be potentially more if the regulation and expectations gets adopted. One, from a supply chain efficiency perspective of our customers, and two other regulatory bodies start implementing the same regulations.

Dan Leonard
Analyst, UBS Securities LLC
Q

And then what would the 6 billion be? Is 6 billion good as well?

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

We will see when changes occur.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay.

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

But again, 25% of our components that we manufacture – the 43 billion components roughly around 38 billion is what I call elastomers and containment. And when you think about only 25% of that is HVP.

Dan Leonard
Analyst, UBS Securities LLC
Q

Okay.

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

So the other 75% is the opportunity.

Dan Leonard
Analyst, UBS Securities LLC
Q

Maybe in the last minute here, how do you see margins developing over the next 12 to 18 months?

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

Yeah. So the tailwinds that we have on margin is – assuming biologics, generics get back to more of a normalized run – get rid of the destocking effect and also the growth profile get back to more normalized. We believe the margin profile will get closer to what we had in 2023. We also – from a headwind perspective, obviously, the work that we're doing with our wearable device, we talked about already the three levers that we're going after, that will go from a headwind to working on a tailwind, because the expectation there is be at the level of our HVP average. The other headwind that we have is some depreciation on the short term of these new assets we put on as we scale up, but that will dissipate over time. And then one smaller area is incentives, that's obviously a headwind for us.

Dan Leonard
Analyst, UBS Securities LLC
Q

What was that last one?

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

The incentives.

Dan Leonard
Analyst, UBS Securities LLC
Q

Incentives. Okay.

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

Yeah. Absolutely. When we reduced the guidance in Q2, obviously, we don't change the targets for us. And so therefore, the payout will be most likely less than we anticipated.

Dan Leonard
Analyst, UBS Securities LLC

Q

Got it.

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

A

You know, I always – I really like to go more than 100% payout, and that's what we will focus on going forward in the following years, but this year will be less. And therefore, there will be – I would consider that a headwind in the next 12 to 18 months.

Dan Leonard
Analyst, UBS Securities LLC

Q

And so that would reset in 2025?

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

A

Yeah.

Dan Leonard
Analyst, UBS Securities LLC

Got it. Okay. Great. Well, with that, we're out of time. We covered a lot of ground.

Eric, thanks for joining us.

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

Thank you for your time.

Dan Leonard
Analyst, UBS Securities LLC

John, thank you.

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

Thanks, Dan.

John Sweeney
Vice President-Investor Relations, West Pharmaceutical Services, Inc.

Thank you, Dan.

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

Appreciate it.

Dan Leonard
Analyst, UBS Securities LLC

Thank you.