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West Pharmaceutical Services, Inc. (WST)

Q3 2017 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the third quarter 2017 West Pharmaceutical Services Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions]

As a reminder, today's program is being recorded. I would now like to introduce your host for today's program, Quintin Lai, Vice President of Investor Relations. Please go ahead, sir.

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

Thanks, Jonathan.

Good morning, and welcome to West's third quarter 2017 conference call. We issued our financial results this morning and the release has been posted in the Investors section on the company's website located at www.westpharma.com.

This morning, CEO, Eric Green, and CFO, Bill Federici, will review our results, provide an update on our business and financial outlook for the full year 2017, a preliminary look at 2018 sales guidance, and our long-term financial construct. 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 risks or uncertainties, actual results could differ materially from past results and those expressed or implied in any forward-looking statements.

For 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 by the company 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, 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 M. Green

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

Thank you, Quintin, and good morning, everyone.

Our team had a solid performance in the third quarter, which was in line with our expectations and consistent to prior quarter performance. Importantly, we saw an improved to positive growth in our Generics market unit and continued strength in our contract manufacturing business. We believe we are on track to finish 2017 with strong organic growth led by high-value product sales in the Biologics and Generics market units.

I want to start this quarterly review by addressing the impact from the hurricanes during Q3. Our highest priority is always the safety of our employees. And I'm pleased to report that all our employees and their families made it through the storms unharmed. Our team did an excellent job of pre-storm preparations and post-storm cleanups and restarts.

Puerto Rico continues to be a challenge. Damage to the regional infrastructure is extensive and is affecting our employees and customers on the island. Our facilities saw minimal damage and we are now partially operational due to the use of backup onsite generators. I'm proud of our employees and how they rose to meet the challenges of these storms, and we at West are committed to helping them with ongoing relief efforts.

In the third quarter, we estimate that the weather shutdowns caused the negative sales impact of $2 million – over half to Biologic (sic) [Biologics] (04:06) located on the island and the balance to contract manufacturing customers. In the fourth quarter, we could see another $5 million of sales impact, mostly due to delays in shipments to Biologic (sic) [Biologics] (04:20) customers in Puerto Rico. This risk is reflected in our revised 2017 guidance. Bill Federici will go over the Q3 financial details in a few minutes. So, let's move to Slide 4 for a discussion on the trends we saw on our specific market units and businesses.

We've generated 4% organic sales growth in the quarter and remain on track to generate approximately 6% for the full year 2017. Contract manufacturing had another double-digit organic sales growth quarter. Our enhanced focus on serving customers in the drug delivery and diagnostics market is yielding strong performance. And we're encouraged with the expanding pipeline of new projects that is offsetting slower growth from our consumer products' customers. We expect some moderation as we anniversary its strong Q4 from last year. And we expect to generate high single-digit growth for the full year.

In our Pharma market unit, we had a slowdown from a few large customers after a strong first half of the year. We remain on track for a full year organic sales performance of mid-single digits.

In Biologics, we had a low-single digit sales growth. If we add back the late sales from the hurricane, growth would have been mid-single digits and in line with our expectations. We remain on track for double-digit growth in Q4 and high-single digits for the full year.

And finally, I'm pleased to report that Generics returned to organic sales growth in the third quarter. We are seeing more typical demand trends from our larger customers as their inventory management has stabilized. The Generics unit is on track to deliver double-digit sales growth in Q4, and we expect the full year to be flat compared to the prior year.

Turning to slide 5. We often talk about our high-value component strategy that encourages our customers to move up the quality chain from standard packaging components to higher value offerings, such as Westar RS, RU, Envision, and NovaPure. This mix shift has been fueling our organic sales growth, and we expect it to continue to drive growth in margin expansion for the foreseeable future. On this slide, we highlight new products that have been featured in recent press releases and will be featured at upcoming trade shows.

Our industry is known for long customer adoption curves and that is why we constantly strive to build a diverse portfolio of innovative products that will fuel our future growth. In Q3, we had another strong quarter for recently launched Envision and NovaPure components.

These offerings address the highest quality requirements in the industry. And we are expanding our high-value product portfolio with a new elastomer portfolio offering called AccelTRA. AccelTRA packaging component helps generics manufacturers meet increase in quality standards, ensure fast response to market volatility and move their product to market quickly. We are pleased with the initial reception to AccelTRA. More than 30 customers have requested samples and a number of these have started formal stability trials.

This slide also mentions the Westar ID Adapter. We have a growing portfolio of administration devices used in hospital, healthcare, and home settings. The ID Adapter is used by healthcare providers to enable successful intradermal injections. We recently highlighted a WHO study that use the ID Adapter in a trial for dose-sparing polio vaccinations.

Our wearables portfolio is also expanding. At the November PDA conference in Vienna, we will feature extensions of our SmartDose drug delivery platform with enhanced usability and performance capabilities such as Bluetooth connectivity to drive patient adherence. The expanded portfolio will now include dosing options as large as 10 mL.

As you can see from the small example of the new products, we focused our R&D investments to broaden our product portfolio that includes high-value product components, wearable injectors and administration systems our customers seek.

On slide 6, we have updated full year 2017 guidance. We continue to expect approximately 6% organic sales growth for the full year. And we are raising the sales guidance range based on our Q3 performance, and a slight tailwind in FX offset by hurricane-related impacts in Puerto Rico. We are also raising our adjusted EPS range to $2.74 to $2.79.

Turing to slide 7, 2017 has been a transition year as we continue to work through our customers' inventory management activities that started at 2016. We expect the return of a more typical growth pattern in Q4 of this year.

Looking forward to 2018, we expect organic sales growth in the range of 6% to 8% as a result of market volume growth and continued high-value product conversions. Our long-term outlook remains consistent with 6% to 8% annual constant currency organic sales growth. As we have stated in the past, we expect on average about 1 point to come from price, 2 to 3 points from market volume and 3 to 4 points from market shift. A significant portion of our component volume sales is still in standard format, and with the increase in quality focus of our customers, we feel that we have significant opportunity for converting standard products to high-value products.

Anticipating increased volumes over the next few years, we are also expanding our manufacturing capacity, including the completion of our Waterford site, which should commence commercial production in mid-2018.

And as you saw in the prior slides, we have a portfolio of proprietary devices that will accelerate our growth as they gain traction in the marketplace. We expect gross margins to expand as product mix continues its trend towards high-value products. This, combined with the numerous initiatives to improve manufacturing efficiencies that our global operations team has put in place, will further improve our cost structure. We expect to benefit from operating profit margin expansion, on average, of 100 basis points per year for the next several years as a result of these activities.

CapEx is expected to be in the range of between $150 million to $175 million. Our preferred capital allocation is to invest in our high-value growth products. We believe these investments will fuel the development and launch of the next generation of integrated containment and delivery solutions we know our customers are counting on us to deliver.

I'll now turn it over to our CFO, Bill Federici, who will take you through our detailed financial results for the quarter. Bill?

William J. Federici

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

Thank you, Eric, and good morning, everyone. We issued our third quarter results this morning reporting net income of $51 million or $0.67 per diluted share. As a reminder, 2017 earnings per share include tax benefits on stock compensation due to an accounting change effective at the beginning of 2017. Our third quarter 2017 results include a $0.06 per share tax benefit due to this change. Our Q3 results also include a $0.09 per share reimbursement of prior costs incurred in the development of a safety technology we licensed to a third party. That amount is included as other operating income in our Q3 results.

Our adjusted diluted earnings in the third quarter of 2016 were $0.53 per share. A reconciliation of non-GAAP measures is included on slides 14 through 17 in the presentation that accompanies this call.

Turning to sales. Slide 9 shows the components of our consolidated sales increase. Our consolidated third quarter sales of $398.2 million increased by 5.7% versus our third quarter 2016 sales. Excluding the $7.7 million favorable foreign exchange effect, our Q3 2017 sales increased 3.7%. Proprietary net sales increased 1.5% versus the same quarter 2016, excluding exchange. And the vision-inspected components and SmartDose devices saw the highest sales increases. Sales of our high-value product offerings rose 1.1% versus the prior year third quarter. Current quarter high-value product sales as a percentage of total proprietary products sales was flat versus a year ago.

Both Q3 2016 and the first nine months of 2016 saw significant growth in high-value products, up 24% and 21% respectively versus their prior year comparators due to strong customer demand, especially in our generics and biologics market segment, as customers ramped up the product launches and were reacting to our lengthened order lead times in our facility. Our combined Q3 revenues from CZ and SmartDose of approximately $9.5 million were $1.7 million or 22% more than the combined 2016 Q3 sales. Contract-Manufactured net sales increased by 11.5% versus the prior-year quarter, ex-currency, driven by the ramp up of customer activity in our newly completed Dublin contract facility.

As provided on slide 10, our consolidated Q3 2017 gross profit margin of 31.4% was 0.7 margin point lower than the margin we achieved in the third quarter of 2016. Proprietary third quarter margin of 35.8% was 0.6 of a margin point lower than the margin achieved in the third quarter of 2016.

The decrease in gross margin is due to higher production overhead and depreciation, partially due to preproduction activities at our new Waterford site, with a negative product mix and modest price increases. HVP sales growth slowed as certain Biologics and Generic (sic) [Generics] (15:27) customers continue to work off high levels of inventory acquired as part of product launches and in response to our previous long order lead times.

Contract-Manufactured third quarter gross margin increased by 0.3 of a margin point to 16.3% due to the favorable mix of products sold and volume increases, which were partially offset by higher labor increased overhead costs associated with new capabilities supporting contract manufacturing customer programs, especially in our expanded Dublin facility.

As reflected on slide 11, Q3 2017 consolidated SG&A expense increased by $3.2 million versus the prior year quarter. Higher compensation costs and outside services expenses were partially offset by lower pension expense.

As a percentage of sales, third quarter 2017 SG&A expense was 15.4% versus 15.5% in the third quarter 2016. Third quarter 2017 other income was $9.5 million. The majority of this is due to the $9.1 million reimbursement of prior cost incurred in the development of a safety technology, we licensed to a third party.

Slide 12, shows our key cash flow and balance sheet metrics. Our year-to-date operating cash flow of $181.8 million is $34.2 million above what we generated in the first nine months of 2016 due to higher net income, lower income tax payments and the inclusion of the tax benefit on share-based payments, offset by higher pension contributions.

Our capital spending was $101.3 million for the first nine months of 2017, approximately $21 million less than at this time in 2016. We expect to spend up to $150 million in capital in 2017. Approximately 60% of our planned capital spending is dedicated to new products and expansion activities, including approximately $25 million for the construction of the new Waterford facility.

Our balance sheet continues to be strong and we're confident that our business will provide necessary future liquidity. Our cash balance at September 30 of $269 million was $66 million more than our December 2016 balance, the increase reflects the operating cash flow generated so far this year, net of our capital expenditures and 26.9 million in share repurchases. Our cash balance also increased due to the positive currency effect.

Debt at September 30, 2017, of $229.8 million was $1.2 million more than at year-end. Our cash balance exceeds our debt balances, as such we are de-levered on a net debt to total invested capital basis. In the fourth quarter of

2017, we paid off the $33.1 million remaining mortgage balance on our headquarters building that was scheduled to mature in January of 2018, which will generate a small Q4 benefit from a lower interest expense.

Working capital of approximately $477 million at September 30, was $76 million higher than at year-end. The majority of increase is due to increases in our cash balances, accounts receivables and inventory balances partially offset by higher accounts payable in accrued expenses as well as the reclassification to current of our headquarter building mortgage. The accounts receivable increase was due to higher sales in currency effects on our international receivables, as well as extended payment terms by certain customers.

Looking ahead, our committed proprietary product orders were $375 million at September 2017, 6% lower than at September 2016 excluding exchange. As expected, due to the operational gains resulting in lower lead times in our plants, customers do not need to place orders as far in advance, which has had the effect of lowering committed orders on hand.

Based on our year-to-date 2017 results and our analysis of the orders on hand, we have revised our full year 2017 guidance in this morning's release. That guidance is summarized on slide 13. We anticipate Q4 sales in our proprietary business to return to more normal growth rates.

Additionally, we expect a return to mid-single digit growth in our contract manufacturing business. Our Q4 results may be adversely affected by up to $5 million of sales and $0.03 of EPS by the recent hurricanes that have affected our facility and our customers' facilities in Puerto Rico.

Our contract manufacturing facility in Puerto Rico has restarted partial production. We now expect full year adjusted diluted EPS to be in the range of $2.74 to $2.79. We have based our guidance on an exchange rate of $1.18 per euro for the remainder of 2017 versus the $1.14 per euro rate used in our prior guidance.

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

Eric M. Green

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

Thank you, Bill.

In conclusion, we're seeing good progress with our market-led strategy. With quality, scientific and technical expertise that is unmatched in our industry, we are developing deep insights into what our customers need and are developing unique solutions for them.

We have a strong pipeline of innovative high-value products and delivery devices that will address future market needs. And our operations team is working to apply manufacturing excellence and best practice across our global network to deliver better service to our customers and reduce costs.

With strong market fundamentals driving our business, our team is focused on delivering the year-end for our customers and laying the groundwork for future success in 2018 and beyond.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Dave Windley from Jefferies. Your question, please.

Jared Meggison
Analyst, Jefferies LLC

Q

Guys, this is Jared Meggison on for Dave Windley, thanks for taking the questions.

A

Hi, Jared.

Jared Meggison
Analyst, Jefferies LLC

Q

I just want to dive a little deeper into the backlog being down 6%. I know you talked about longer lead times, but I just wanted to touch on the efficiencies that you guys are getting in your proprietary products. I know you previously discussed some increased efficiencies in your manufacturing processes. So, I guess, what I'm curious about is, are you guys continuing to get efficiencies or was that more of a one-time gain, and now you're just operating more efficiently and seeing lower orders, or can you just expand on that?

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

A

It's a very good question. And we have seen over the last year and a half, two years, a reduction – a significant reduction from lead times that were somewhat inflated end of 2015, going into 2016, due to surge of demand really in the Biologic – I'm sorry, in the Generics space for our high-valued products. Because of the improvements we made in Jersey Shore facility in Pennsylvania, also the investments we made with Kinston, North Carolina, we're able to add capacity, which has, as I mentioned, reduced the cycle times significantly.

I would argue, at this point, we're not satisfied where we are. If we'd mentioned we talked a little bit about AccelTRA, that's a program that's designed to take lead times that could be anywhere between 10 to 15 weeks, down to less than half that. So, we're continuously with the continuous improvement mind-set driving more efficiencies. And you're right, the net result is our customers are less dependent on putting orders out two or three quarters in advance to more in just in time mentality. So, we're making good progress, but we have more work to do, and we're seeing the benefit with more of the response from our customers.

Jared Meggison
Analyst, Jefferies LLC

Q

Great. Thanks for that. And then, regarding the hurricane impact in 4Q, I know you quantify the revenue as potentially $5 million. Can you maybe quantify what that does to margin? Is that kind of a flow through there or what are the expectations around that?

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

A

Yeah, the margin impact, Jared, will be an adverse impact, about $0.03 on the EPS line, so about $3 million of operating profit.

Jared Meggison
Analyst, Jefferies LLC

Q

Okay, great. And then...

[indiscernible] (24:18)

Jared Meggison
Analyst, Jefferies LLC

Q

Got you, okay. And then, last one for me. I think you guys had mentioned Generics was expected to grow double-digits in 4Q. If you could just expand on that expectation; is that a normalization of the regulatory issues we had seen in 2Q, 3Q, or have you guys had some larger orders come in?

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

A

Yeah. It's really the work our customers, the Generic (sic) [Generics] (24:43) customers have done on their inventory management. Again, over a year ago, they built up inventories due to the long lead times. They got really comfortable towards the tail end of 2016 where we were and with the continuous improvement, and that has really anniversaried out during the Q3 of this year.

As you know, we're a make-to-order environment, so we have visibility of orders on hand that we're currently working on the delivery with expectations in Q4 with generics. So it really is around the inventory management activities that were done by our customers.

Jared Meggison
Analyst, Jefferies LLC

Q

Great, thanks, guys. Appreciate the answers.

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

A

Thank you.

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

A

Thanks, Jared.

Operator: Thank you. Our next question comes from the line of Larry Solow from CJS Securities. Your question, please.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Hi. Good morning. Just a couple of follow-ups. Just on the lead time question, as you guys, obviously, this is your own successes demonstrated here, that the lead times eventually – does there come an inflection point when this begins to go the other way, or is it that tight now for the customer, or that much better for the customer that this

will always be something with very little lead time? And do you guys see benefit from that? Obviously the customer can hold less inventory, you hold less raw materials on hand. Is that actually driving better profit for you?

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

Yeah, Larry, it's a benefit for both our customers and for ourselves. And frankly, I think we've more normalized in the last couple of quarters or three quarters, I would argue, with our operations on lead times. And as the global operations team's looking at putting in place continuous improvements with more automation, more process flow designs, it gives us the ability to continuously drive that lead time down further to continue to be the best in class in the industry, frankly. But you're right, while we're able to create more efficiencies, we drive costs out of our customers working capital, higher quality and delivery faster to our customers will translate into better margins, for less.

Larry S. Solow
Analyst, CJS Securities, Inc.
Q

As this – the improved throughput and increased capacity, I suppose, it's freed up even additional capacity that allows you to grow it or even look for other opportunities that maybe you couldn't do, not too long ago.

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

Yeah, Larry, so that's a very good point. We had some constraints moving customers from standard packaging components to high-value products about a year and a half ago, just due to constraints of our operations. With the lower lead times, the conversations with customers to move more of their portfolio towards high-value products is a lot easier. And you know what comes with that, right? It's higher revenues and higher margins per transaction. So that's going to be a benefit as we go forward, and we know the global operations team is really focused on maintaining and improving on those metrics so that our commercial organization has that confidence with the conversation to our customers.

Larry S. Solow
Analyst, CJS Securities, Inc.
Q

Great. And just a couple question on the specific end markets. On the biologics side obviously, it's been held back by the aforementioned inventory issues. Sounds like you guys are – you're pretty confident with a high-single digit growth for the year. You'll obviously get into the double digits in Q4. As you look out more importantly into 2018, is a double-digit growth rate sort of incorporated into that sort of 6% to 8% overall growth in next year?

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

Yeah.

Larry S. Solow
Analyst, CJS Securities, Inc.
Q

On the biologics side?

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

You're right, in the biologics. We're starting to see that more normalized in Q4. Actually outsized, I would say, with double digits. It's very strong double digits. And as we look into 2018, what we're seeing with our customers and conversations with our customers will be back to more normal levels. And that could oscillate between – quarter to quarter between the high singles or the low double, but it's in that corridor.

Larry S. Solow
Analyst, CJS Securities, Inc.
Q

Got it. And then, just lastly, on the generic area, I know you guys had some – a lot of timing and whatnot impacted you guys, but also there has been some slowdown in the production industry-wide, a lot more, it seems like a little tighter regulations or at least more warning letters, FDA audits and whatnot. Any change in that front? Any reaction from customers?

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

Larry, there's been not a lot of change on that regard, specifically around India. We are continuously working with our customers as they work through these issues. I would say, though, we had a pretty strong performance; not just in India, but throughout Asia in Q3. So we think it's coming back to more normal type of performance. I just wanted to remind you that our business in India was mostly impacted by these regulatory hurdles is a very small piece of our Generics business. In fact, it's less than 5% of our entire Generics business.

Larry S. Solow
Analyst, CJS Securities, Inc.
Q

Right, great. Thanks for reminding me that. Appreciate that. Great, thanks, guys. I appreciate it.

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

Sure. Thank you, Larry.

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

Thanks, Larry.

Operator: Thank you. Our next question comes from the line of William March from Janney Montgomery. Your question, please.

William March
Analyst, Janney Montgomery Scott LLC
Q

Hey, guys. How are you?

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

Hey, Bill.

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

Good morning.

William March
Analyst, Janney Montgomery Scott LLC

Q

First question, maybe just talk about the adoption curve you're seeing for NovaPure, and Westar, Envision. And maybe how does that compare to some of the legacy HVP products like Westar RS and RU, and kind of just the long-term dynamic of that shift, and then the shift of standard to high-value products.

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

A

Yeah. So, Bill, when you look at the NovaPure and Envision and if you can just kind of think about the – our product portfolio, moving up to high value quality curve, these are the services and product solutions that we offer our customers, are more recently launched. And what we're seeing is a lot of interest, because Envision, obviously, gets into sub-visible detection of defects.

And against NovaPure, that's really quality by design. Both of them though are very small as an overall percentage of our high-valued product portfolio, but the migration from either standard to that part of the portfolio or even from typically Westar RU, RS, FluroTec, all the way up to NovaPure, has continued to be very attractive for our customers.

To give you an example, NovaPure manufacturing capability, we came online about – almost a year ago in Kinston, North Carolina. It's been validated. We're working with customers on stability. So, we can move their highest level of Biologics on NovaPure.

And the economics are quite attractive. Obviously, for our customers these days, reducing their defects and improves our quality. And for us, it's actually moving – helps us with our gross margin, obviously.

So, we're excited about it, but it's a small number, and got to be careful when we talk about very strong growth. But it's a long migration, but it's exciting to see the traction we're getting from our customers.

William March
Analyst, Janney Montgomery Scott LLC

Q

Got it. And then on the Pharma segment, I know in the last call, you called out a major customer that's going to be migrating from standard to high-value products beginning in 2018. Are you seeing – are you having conversations with additional Pharma customers about that?

And then, maybe is that going to be a little bit of a headwind here in 3Q and 4Q as that customer works down standard inventory as they begin the migration?

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

A

No, I think what you're going to see is – so to answer your question, the first part is yes, we are continuing to have conversations; that one particular customer have migration that's commencing in 2018. We're quite excited about it, because it supports one of their major initiatives of driving for zero defect; that they're within their organization, but also enables us to put our highest quality product on their products.

Secondly though, we'll see a little bit of a transition, you could argue there might be a little bit of headwind, but we're managing through that with our customer as they migrate and we don't see too much volatility. But you'll see this quarter in Q3 the volatility that we saw really is a follow-on of a very, very strong first half. And the sales of the first half are led by packaging components for insulin delivery. This reminds you we have a pretty strong position in the diabetes market.

And so, the outsourcing growth in the Envision administration system products also. So, we don't think Q3 is a typical – a concern because this is the typical normal quarterly fluctuation, and we continue to believe a mid-single digit in pharma is to be expected.

William March
Analyst, Janney Montgomery Scott LLC

Q

Got it. And then, just one quick one for Bill. Could you maybe just talk about capital deployment and now what's the net cash balance, where you guys stand on your thoughts around share repurchases and maybe accelerating that? Thanks, guys.

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

A

Sure. Thanks, Bill. So, absolutely, as Eric mentioned in his prepared remarks, our first order of business is to invest back into the core of our business, the high-value product programs. That will continue to be our initial first pass on capital allocation.

We do have a board authorized share buyback program that runs through the end of the year. And we are – as we mentioned, we've taken down a part of that and there's still a piece to go that's available to us under that program. And we have affected about $26.9 million through the first nine months of the year. In terms of how we're looking at the balance sheet, we're very comfortable with our balance sheet, the way it is. We believe that it continues to provide us with the necessary liquidity to be able to continue to grow our high-value product programs and our proprietary delivery systems as well, since no fundamental change in that in the near term.

William March
Analyst, Janney Montgomery Scott LLC

Q

Thanks, guys.

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

A

Thank you.

Operator: Thank you. [Operator Instructions] Our next question comes from the line of Tim Evans from Wells Fargo. Your question, please.

Q

Good morning, guys. This is actually [ph] Robin (35:47) on for Tim. Thanks for taking my question.

[indiscernible] (35:50)

Q

So, we see only this one situation where biosimilars are taking more than expected share from innovators. Do you guys see this dynamic as disruptive to West in the short term, possibly some customers might adjust their inventory?

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

A

Biosimilars are very new in this space at this point, and it's – obviously, in long term, it's a very attractive space. We are looking at large molecules. And we don't see – we believe, our position in that part of the market is actually very attractive. To give you an example, in Q3 there were – we believe there's 14 NMEs that were approved, of which seven were biologics, about four were biosimilars, and three were small molecules. We were in all of those presentations.

So it shows that we're not just in the biologics or small molecules. We have a very good position in the biosimilar space.

Q

Okay, great. Thanks. And really quick, contract manufacturing was pretty strong in the quarter. And I know you mentioned, you saw minimal damage in backup and [ph] partially (36:55) operational, but is there anything else you can comment on regarding strength?

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

A

Yeah. So the team has done a really good job with contract manufacturing. This is a business that has – and I'm pleased with the leadership team in that part of the organization where they have really focused intently in the diagnostics and the med device space.

And as you know, if we were to say, you're talking about three years ago, I think there was a pretty robust part of the portfolio is in consumer products. And while that's a very important area, our focus has really been towards the healthcare space. And today, less than 20% of our sales of that business is in consumer products. The growth really is coming from product launches of our customers with new molecules and new delivery devices going into the market. And we're – for example, in Dublin, we've built a facility dedicated for a line for delivery device and that delivery devices ran in troubles keeping up with the volume, frankly.

And so, that's a great example in how we're – the focus has given us more opportunities and the pipeline looks very rich. So, it is – for me, a tough comp in Q4, but that team is well positioned to continue to grow that business very well.

Q

Okay, great. Thank you very much.

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

Thank you.

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

Thank you.

Operator: Thank you. Our next question comes from the line of Derik DeBruin from Bank of America. Your question, please.

Derik DeBruin
Analyst, Bank of America Merrill Lynch
Q

Hey, good morning.

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

Morning, Derik.

Derik DeBruin
Analyst, Bank of America Merrill Lynch
Q

Good morning. Hey, couple of questions. Hey, Bill, I'm just curious, the reimbursement to 9.1 or the 9.5 reimbursement for cost, you'd originally guided to $0.53 flattish EPS number for the quarter and the conversation was if this was going to come in 4Q, and it was going to be a smaller magnitude, I think around $8 million. I guess, what changed in terms of timing given the call was on July 27?

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

I mean, nothing changed in terms of timing. I mean, these are deals that happen when they happen. But we are – I think we were very clear on what we expected. The number was a little different than what we had originally said. But the $9.1 million is running through other operating income, and we did say that was going to be in Q3, not Q4, Derik, just to correct you there. And the 8 million versus $9.1 million, the 8 million was euros. And so that -

Derik DeBruin
Analyst, Bank of America Merrill Lynch
Q

Got you. Okay. Okay. Hey, and I guess, just I'm curious, the stock-based accounting changes are – I think, it's like a $0.40 tailwind when you've had this year with that. I mean, how do you look at that in terms of next year in terms of comps? What sort of headwind does that create from a [indiscernible] (39:57) standpoint?

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

Yeah, thank you, Derik, it's a great question. This is an area where there's new accounting, used to run through the equity section, now the accountant has decided it should go through the income statement. We had very, very high levels of activity. As you know, the excess tax benefit is based on a lot of different variables, first one being the existing stock [indiscernible] (40:34) the strike price of those options at the time they were given. So, there's a

number of variables that are involved – very, very hard to predict when individuals, either being retired individuals or individuals that are still at the company, are going to exercise their options. So we've been transparent in terms of what the actual results have been. I can tell you, if you look back in history, the amount is in prior years even though it's run through the equity section, has not nearly been as high as what we've seen this year. It's about $19 million in 2016 and smaller amounts before that.

So, while there are still options out there that are available to be exercised, describing for you how we could possibly predict that going into the future is very difficult because of those various variables, including what happens with tax reform going forward. Those are things that make it extraordinarily difficult. We think the best thing to do is to be transparent, but if you're – in terms of helping you understand what's hit the particular period? But if you're trying to think about it, I wouldn't use the $30 million that we've seen thus far, the $0.40. I would think more in lines with what we've seen in the past, which has been kind of in that $10 million to $18 million range. So we will continue to update you as we go along, but predicting something like that is very, very difficult.

Derik DeBruin
Analyst, Bank of America Merrill Lynch

Q

Great, that's really helpful. And then just one final question. I guess when you sort of look at the – I think, the 6% to 8% long-term number and the 100 basis points of margin expansion sort of built in. I mean, that's sort of what we were running through our models. But I guess if you look at the – this sort of puts the op margin number by 2020 versus your prior guidance sort of at the lower end of that range of that. I guess what's the delta – I guess what's still the biggest delta in terms of potentially getting from what now looks like the 19% to 23%, which you said previously? Is it still mostly FX and proprietary and sort of the new product sets that were coming in as the big deltas and sort of that margin number?

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

A

Yeah. I think, Derik, what we're saying is that construct, the 6% to 8% growth organically, driven by the mix shift to high-value products and the increased optionality in terms of growth coming from our proprietary devices, is going to drive, along with operational efficiencies, is going to drive approximately 100 basis points on average each year to our operating margin.

We still feel very, very comfortable with making those claims. And we've actually seen this result, when high-value product growth is high, in that high singles to low double that we expect it to go over the long periods of time; that generates very, very good margin; there's a great correlation between that in generating good margin expansions. So, those – that construct along with our operational efficiencies gives us a lot of comfort that we're going to continue to grow in approximately 100 basis points on average per year.

Derik DeBruin
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks.

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

A

Thank you, Derik.

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

A

Thank you, Derik.

Operator: Thank you. And this does conclude the question-and-answer session of today's program. I'd like to hand the program back to Quintin Lai for any further remarks.

Quintin Lai

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

Thanks, Jonathan.

Thank you for joining us on today's conference call.

An online archive of the broadcast will be available on our website at www.westpharma.com in the Investors section. Additionally, you can access a telephone replay through Thursday, November 2 by dialing the numbers and conference ID provided at the end of today's earnings release. So that concludes today's call. Thanks and have a nice day.

Operator: Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.