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West Pharmaceutical Services, Inc. (WST)

Q2 2018 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the Q2 2018 West Pharmaceutical Services Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a the question-and-answer session, and instructions will follow at that time. [Operator Instructions] As a reminder, this call is being recorded.

I would now like to introduce your host for today's conference, Quintin Lai, Vice President of Investor Relations. Sir, you may begin.

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

Thank you, Sara. Good morning, and welcome to West's second quarter 2018 conference call. We issued our financial results this morning and the release has been posted in the Investors section on the company's website located at www.westpharma.com.

This morning, CEO, Eric Green; and CFO, Bernard Birkett will review our results, give you an update on our business, provide an updated financial outlook for the full-year 2018. There is 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 laws. These statements are based on management's beliefs and assumptions, current expectations, estimates and forecasts. There are many factors that can influence the company's future results that are beyond the ability of the company to control or predict.

Because of these known or unknown risk and uncertainties, actual results could differ materially from past results, and those expressed or implied in any forward-looking statement. For a non-exclusive list of factors, which could cause actual results to differ from our expectations, please refer to today's press release as well as any further disclosures the company makes regarding the risks to which it is subject in the company's 10-K, 10-Q and 8-K reports.

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

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

Eric Mark Green

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

Thank you, Quintin, and good morning, everyone, and thank you for joining us today. Before we start the review of our financial results, I am pleased to welcome to the call our newest member of the team, Bernard Birkett. Bernard joined us as CFO in late June. And you will hear more from him later today. Our outgoing CFO, Bill Federici, is actively working with Bernard in this transition period. And I want to take a moment to thank them.

As many of you know, Bill has been a critical contributor to West and our company's success over the past 15 years. He's also been a tremendous mentor and leader for his team as well as a great friend and colleague to his peers and to me. We thank him for his service, and we wish Bill and his family all the best as they embark on the next chapter of their lives, following his retirement from West.

Turning now to the financial results, this morning, we reported our second quarter performance. We have solid sales growth in our Proprietary Products segment led by double-digit growth in our high-value products. We also saw a strong sales growth in our Contract Manufacturing segment. Because of this strong top line performance, we saw consolidated gross and operating margin expansion in the quarter, in addition to adjusted EPS growth of 25% year-over-year excluding stock option tax benefits. With the first half of the year in the books, we are reaffirming our overall 2018 sales and adjusted EPS guidance.

As Bernard will review in his comments, you will see that this guidance assumes a lower euro exchange rate for the second half of 2018 than previously reported. Slide 4, showed our organic sales performance by quarter across both segments of our business. In the second quarter, we had organic sales growth of 9%, the highest level in the past seven quarters.

The Proprietary Products segment grew organically 7% over the prior year with growth coming from all three markets units in all geographies. Looking at our individual proprietary market units, let's start with Biologics, as we expected and outlined last year, we saw a return to positive organic sales growth in Q2.

Our customers in this area continue to turn West for our high-value products to contain and deliver the sensitive biologics. A few of our large customers are still affected by prior prelaunch activities and inventory management primarily around self-injection systems. But everything we hear from our customers leaves us to believe that we will see continued improvement in the growth rate for the Biologics market unit for the full-year.

Our Generics market unit had double-digit organic sales growth this quarter, fueled by stronger high-value product sales, led by Westar RU, SelfDose, and Envision products. As we look at the second half of the year, the comps starts to normalize, and we expect Generics to grow in the mid- to high-single digits for the full-year.

Our Pharma market unit returned to positive growth after three consecutive quarters of decline. Consistent with the other market units, we experienced strong high value product growth. We believe our Pharma customers are beginning to normalize their order patterns, following the execution of inventory management programs. As we look at the back half of the year, we expect growth to accelerate as we face more favorable comps from last year. We also believe the additional investments we made in Puerto Rico to expand our capacity for administration systems will lead this marketing unit growth in the mid-single digits for the full-year.

Turning to Contract Manufacturing, this segment had strong sales quarter with 17% organic growth. Healthcare customers represent 88% of the Contract Manufacturing sales. And sales to these customers had strong double-digit gains in the quarter. We are pleased with the success we've had in this area of business. However, in response to our customers' increasing demand requirements, we're experiencing some growing pains in the form of labor and operational cost to have impact to the margin this quarter. Bernard will cover the detail around this and how we see this recovering.

As we look through the rest of the year for Contract Manufacturing, we expect full-year sales growth to be in the high single digits, even in face of a very tough comp in Q4. As a reminder, Q4 2017 had a significant amount of tooling sales that has generated the strong recurring sales growth we're now seeing in 2018.

We now move to slide 5. We are pleased to announce that several of our newly-launched products received industry recognition this quarter, and we introduced another new product category, Westar Select, adding to our already strong high value product portfolio.

Our AccelTRA component program was recognized with the 2018 India Packaging Award in the category of Packaging Design in Injectables. AccelTRA was designed for customers like those in our Generics market unit that are demanding high-quality components, reliable supply and speed to market. I'm pleased on how this program is resonating with our Generics customers.

In June, the company received a Medical Design Excellence Award for Drug-Delivery and Combination Products for our SelfDose patient-controlled injector. The honor was presented to West and our customer, Accord Healthcare Limited, who launched their Methofill SELF INJECT product in the UK and Ireland this year, using our SelfDose injector technology.

And last week, we announced the launch of a brand-new product line, Westar Select. In addition to a tighter particulate specification, this product line will be made available through an optimized global manufacturing network to ensure continuous supply, while helping to streamline our customers' regulatory submissions. These products are made stronger by the deep technical team that stands behind them, and serves as a valuable resource to our customers.

On slide 6, we have outlined examples of technical customer engagement in support of our customers and our own scientific advancements. These milestones demonstrates the continued momentum we are seeing as we work to further position our company as the scientific destination for containment and delivery of injectable medicines. I think it's fair to say that our customers see us as a leader in this space. We have worked hard to achieve this recognition and plan to continue to invest and expand our capabilities in this area of our business.

On slide 7, we present some highlights from the accomplishments of our Global Operations team in the quarter. Last week, we officially opened our Waterford, Ireland facility. Waterford is designed to be a global center of excellence for West's advanced manufacturing network. Recently, the site successfully completed its ISO audits and now holds and maintains active Drug Master Files with the FDA and Health Canada.

Achieving these milestones means we are now able to supply commercial products, manufactured under cGMP with the appropriate regulatory documentation to support our customers. We anticipate making commercial deliveries in both insulin sheeting and HVP product later this year.

We're also in the process of launching new capacity for our proprietary administration systems at our site in Puerto Rico. Puerto Rico is a great example of the benefit of managing a worldwide network of manufacturing plant through a consolidated comprehensive system we are now calling One West. This business system provides a framework for continuous improvement in safety, quality, service and cost, while driving lean principles consistently across our global operations.

We're also driving more efficiencies and better utilizing capacity across our global network, while we manage the growth of the business. This is evidenced in the reduction of CapEx spending for the new infrastructure. As noted in today's release, we are reducing our CapEx guidance for the year to $120 million to $130 million compared to the prior guidance of less than $150 million. We also continue to be on track with the restructuring plans, which we detailed in our last call.

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

Bernard J. Birkett

Chief Financial Officer, Treasurer & Senior VP, West Pharmaceutical Services, Inc.

Thank you, Eric, and good morning, everyone. Before I review the details of our Q2 performance, I want to first say how happy I am to be a part of West. With more than 23 years experience working in medtech, working in healthcare has always been a passion for me. So I'm excited to be part of a company that plays such an important role in helping to improve patient lives. West is well-positioned for future growth, and I am looking forward to being a part of that journey. I am grateful for Bill Federici's leadership team to date, and look forward to continuing the legacy of strong financial management that West is known for. So, let's get to the numbers.

In continuing to deliver on the objectives we have set, we are pleased to report for the second quarter reported net sales of $447.5 million, representing strong top-line organic growth of 9% on a constant currency basis; expansion in gross margin to 31.8% versus 31.4% in Q2 of 2017, which represents a 40 basis points improvement. And adjusted EPS of $0.70 as compared to $0.66 last year. Excluding the impact of stock option exercise tax benefits, adjusted EPS grew by 25%. Our financial results are summarized on slide 8, and the reconciliation of non-GAAP measures are described in slides 14 to 18.

Taking a deeper dive into our sales performance, we have seen sales growth in each of our business segments and market units. Slide 9 shows the components of our consolidated sales increase. Proprietary Product sales increased 7%. Price increases accounted of 1.7% of the sales increase. Our high-value product sales increased by 11.7%. The Generics market unit business saw double-digit sales growth in the current quarter as expected.

Pharma market unit sales growth was in the high single digits. And sales to Biologic customer showed low single-digit growth over the prior-year quarter.

Our high-value products represented almost 60% of Q2 2018 sales compared to 57% of Q2 2017 sales. For the full-year 2018, we expect high single-digit sales growth in high-value products. Contract-Manufactured Product net sales increased by 17%. New product launches in late 2017, particularly in our Dublin facility in support of diagnostic and delivery systems for treatment of diabetes are driving much of the increase in sales. We expect high single-digit sales growth in Contract Manufacturing for the full-year 2018.

Let's turn to margin performance and improvements. As provided on slide 10, our consolidated gross profit margin for Q2 2018 was 31.8% versus 31.4% margin we achieved in the second quarter of 2017. Proprietary Products' second quarter gross margin of 37.2% was 180 basis points above the margin achieved in the second quarter of 2017. The increase in gross margin is due to the favorable mix of products sold, pricing and production efficiencies coming from One West initiative, which more than offset $4 million of overhead cost increases in Waterford in preparation for the initial production activities in the second half of the year.

Contract-Manufactured Product's second quarter gross margin of 13.1% decreased by 370 basis points compared to the prior-year quarter. Three items impacted margin. Unabsorbed overhead from one of our facilities in the first half of the year. This facility is now back to normal production levels. Previously announced plants consolidation activities and startup costs associated with launching new programs and increased sales of products with higher purchase material content. We are confident that Contract Manufacturing margins will improve throughout the second half of 2018 as we complete our restructuring activities, continue to improve our efficiency and utilization levels, which are all part of our One West initiative program, and deliver on the new customer programs.

As reflected on slide 11, Q2 2018 consolidated SG&A expense increased by $8.7 million versus the prior-year quarter. As a percentage of sales, second quarter 2018 SG&A expense was 15.6% versus 15.4% in the second quarter of 2017. Foreign exchange increased SG&A by $1.3 million. Higher incentive compensation cost account for approximately half of the remaining SG&A increase. Excluding these items, SG&A grew by approximately 6.8%. For the second half of the year, we are confident in forecasting mid-single digit growth in SG&A.

Slide 12 shows our key cash flow metrics. Operating cash flow was $127 million for the first half of 2018, an increase of $21 million compared to the first half of 2017, primarily reflecting a $20 million voluntary pension contribution made in the prior year. Our year-to-date capital spending is $48.2 million. $18.8 million lower than a year ago, as we have completed our major construction projects in Ireland.

We forecast CapEx spend to be in the range of $120 million to $130 million in 2018. Approximately half of our planned capital spending is dedicated to advanced manufacturing growth and innovation initiatives, with the remainder on normal maintenance, replacement and information systems.

Moving onto some balance sheet takeaways, slide 12 shows our cash balance at June 30th of $225 million, it was $10 million less than our December 2017 balance. During the six months ended June 30th, 2018, we purchased 800,000 shares of our common stock under our board authorized share buyback plan at a cost of $70.8 million or an average price of $88.51 per share. The completion of our share buyback plan and decreased capital spending projections should result in improved free cash flow in the second half of 2018.

Debt at June 30, 2018 of $196 million is roughly the same level at year-end, and on a net debt-to-total invested capital ratio basis, we are completely de-levered. Working capital of $479 million at June 30th was $15 million a year then at year-end. Most of the increases in receivables related to the growth in our business and an increase in our day sales outstanding metrics, partially due to the impacts of the new revenue recognition accounting rules.

So, turning to guidance, on slide 13, we are reaffirming our full-year 2018 sales and EPS guidance range, even with the impact of a lower U.S. dollar per euro exchange rate, which we are forecasting. We anticipate second half gross margin improvement in both our Proprietary and Contract Manufacturing segments, due to sales mix, production efficiencies and plant utilization.

Our projections now anticipate a euro exchange spot rate of $1.15 per euro for the remainder of 2018. Our previous guidance was based on an exchange rate of $1.20 per euro. Our forecast anticipates $9 million or $0.12 per share with tax benefits from stock compensation for the full-year. We expect our 2018 full-year effective tax rate to be in the range of 24% to 25%, excluding the impact of the tax benefit from auction exercises.

So, to summarize the key takeaways for the quarter. We saw solid sales performance across all segments of our business, overall gross margin improvement, EPS growth, and a reduction in our CapEx forecast for the year. Guidance is maintained, and we are on track to deliver on our goals and objectives for the year.

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

Eric Mark Green

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

Thank you. Bernard. And once again, welcome to West. It's great to have you on the team. As we look to the remainder of 2018, we believe our long-term growth trajectory remains strong. Through the execution of our market-led strategy, we are making good progress against our goals and objectives for the year. We are growing Proprietary and Contract Manufacturing sales by engaging our customers within the Generics, Biologics and Pharma markets.

We are developing and introducing new high-quality products and services to address unmet customer needs. And we are leveraging our global operations to operate more efficiently and effectively. These efforts are returning value to our customers and to our shareholders. Our continued progress makes us confident in our growth targets for the short- and long-term, and we look forward to a successful second half of 2018.

Sara, we are ready to take questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of David Windley with Jefferies. Your line is now open.

David Howard Windley
Analyst, Jefferies LLC

Q

Hi. Good morning. Thanks for taking my questions and welcome to Bernard. I wanted to first, I guess, focus on the revenue number and your nice acceleration there. I think one of the factors that you are expecting to impact the second half was the supply out of Puerto Rico and the contribution to Vial2Bag. And I was wondering if that is still basically proceeding on plan, or if perhaps there were some contribution to 2Q earlier than expected? And similarly, were there other, I'll call it, accelerations in other high-value products that help 2Q a little more than you might have expected and we should take into account for our second half thoughts? Thanks.

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

A

Yeah, David, good morning. Thank you for the question. No, in regards to the administration systems, specifically around Vial2Bag, we're still on target with our capacity expansion for the second half of this year, which you've rightly noted it will have our positive impact on our Pharma unit for the second half. What we experienced in Q2, specifically in the Pharma unit, is more around this effort around converting customers to high-value products, specifically, with our elastomers. And we talked about on the past calls where we have a few customers that are making that conversion from standard to high-value products. And it does take time. It's a journey. But we're seeing good progress, good traction, and it's a little bit stronger than we anticipated in Q2.

David Howard Windley
Analyst, Jefferies LLC

Q

Okay. Very interesting. So given that journey, that conversion, once started, I would think, would have a pretty steady positive influence on high-value product sales. Is that fair?

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

A

It does, in the sense, David, that as they convert from standard to high-value products, the new base is with the HVPs, and we'll continue to convert more up to the high-value products. But that will be in the base and continue to have a positive growth for the balance of the year for Pharma.

David Howard Windley
Analyst, Jefferies LLC

Q

If I could just ask one more on the cost side. You have a couple of things, the labor and other cost factors that you called out in Contract Manufacturing and the Waterford opening and ramp there. Are those things that begin to alleviate very quickly? Or essentially, how long does it take you to alleviate the labor issues and scale into the Waterford plant? Thanks.

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

A

Yeah. David, good question. Let me take it in two parts, if you don't mind. One is, let's talk about the gross margins. So when you look at, we have two businesses, the Proprietary and Contract. Obviously, Proprietary, we had higher gross margin in that particular business, about 180 basis point expansion. It's inclusive of about 120 basis point headwind of Waterford. And that really is driven by the high-value products. So as we talked about is that the power of the high-value product really does drive margin expansion as we grow that business near double digits.

In the Contract Manufacture specifically, you're obviously right, we had headwinds in the quarter due to labor and operational startup. And we believe they're dissipating very quickly, and the reason for that is because, specifically towards ramping up in two particular areas, continuous glucose monitoring devices that we manufacture out of Arizona and out of Dublin, the demand from our customers is ramping a little faster than we anticipated. And the second area is around injection device for the diabetes market, we're also seeing very nice expansion there.

If you look at the growth of those two particular areas, that's one of the major drivers that we had 17% top-line growth in Contract Manufacturing and expect strong second half for this year. So we believe, and as Bernard mentioned in his discussion, the gross margin for the Contract Manufacturing will become more in line in the second half of this year and you should start seeing improvement immediately in this quarter.

David Howard Windley
Analyst, Jefferies LLC
Q

Super. Thank you.

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

Yeah. Thanks, David.

Operator: Thank you. Our next question comes from the line of Paul Knight with Janney. Your line is now open.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC
Q

Hi, Bernard, congratulations on joining West.

Bernard J. Birkett
Chief Financial Officer, Treasurer & Senior VP, West Pharmaceutical Services, Inc.
A

Thank you.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC
Q

On Proprietary Products, with your revenue recognition that you're doing there now, what was the impact on the quarter in terms of revenue growth and margin?

Bernard J. Birkett
Chief Financial Officer, Treasurer & Senior VP, West Pharmaceutical Services, Inc.
A

Yeah. We believe it was an immaterial effect on the numbers in the second quarter.

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

Yeah. Paul, most of the revenue recognition challenges that we had year-to-date has been really around our Contract Manufacturing business. But the impact of revenue recognition for the quarter is really minimal for our business.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC
Q

Okay, got it. And then on high-value add products, Eric, is that growth rate changed or has that been lowered a little bit in your view?

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

No. The high-value product growth that we're experiencing is double-digit for Q2. We strongly believe that consistently that business over a period of time should be growing high single, low doubles. So, we believe it's now in a corridor that we anticipate, not just for the balance of this year, but going into 2019 and beyond. Just to remind ourselves on this that the volume of units for high-value product is still less than 20% of our total volumes that we produce annually. So, we do believe that the growth trajectory for HVP still has some ways to go.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC
Q

And then, also on the Ireland facility, are you going to have revenue in the third quarter? Or when do you expect a meaningful amount of revenue out of Waterford?

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

Well, I can – I'm pleased to tell you, we will have some revenue in Q3, however, obviously, we need to do a ramp-up, both for our insulin sheeting and HVP final product – finishing of the final product out of that facility. So, there will be some revenue. It won't absorb that $4 million headwind that we had in Q2 100%. We do believe it's going to take some time. We do have those orders in hand. We're processing them, as we speak, and it'll ramp up gradually over the next several quarters.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC
Q

And then, I'm sorry for so many questions, but the last one is, any color on Crystal Zenith, how is product update looking there for you, Eric?

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

Yeah. Actually it's – we're actually pleased with the progress. And the reason for that is in the first quarter, we had – we participated with two customers and they were approved of final product into the marketplace. The interest level continues to rise. We're seeing various – from early stages to Phase I, Phase II and Phase III, all the way up to the recent drug fillings for approval, as I mentioned two in Q1. And we do have line of sight of another product that was submitted for approval.

So we are feeling positive about Crystal Zenith, which – you start thinking about the opportunities in that particular space, they're still very pronounced, especially in the Biologics area. But we are also starting to get interest in the areas of pharmaceutical, the Pharma market with small molecules. So it's a slow journey, but we're pleased with what we're seeing in the most recent years. That particular part of the business grew well in the double digits, but it's from a small base, Paul, but expectations is still on track.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

Okay. Thank you.

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

A

Thanks. Thank you, Paul.

Operator: Thank you. Our next question comes from the line of Dana Flanders with Goldman Sachs. Your line is now open.

Dana Flanders
Analyst, Goldman Sachs & Co. LLC

Q

Hi. Thank you very much for the questions and congratulations on the quarter. My first one here, can you just elaborate a little bit on the strengths in the CMO business you saw this quarter? And I know in the press release and you mentioned on the call, some benefits from just timing of tooling orders as well as some recent competitive takeaways. Can you just touch on that? How much of the performance this quarter was driven by that? And what we should expect for the second half of the year?

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

A

Yeah. Dana, good morning, and thanks for the question. When you look at the Contract Manufacturing business, just to give a little bit mention on that, we mentioned about 88% or close to 90% of the business is healthcare. We've been making that transition away from consumer products and mostly focused around, obviously, the healthcare, including diagnostics markets. And we are having some really good success. We believe that particular market is growing, let's call it, mid-single digit. That's our expectations, but we're growing faster than that. And it's because of what you indicated, we're having some competitive takeovers and winning new contracts.

The two areas of that 90 – roughly 90% of the business, above, a little bit less – about a half of it is really going to our Biologic customers. And to give you an example we're having ramp up of an injection device for the diabetes market for one of our customers. And fortunately not just the Contract Manufacturing of the device, but we also participate with the NOVACHOICE plunger, which is a high-value product for us in that particular unit.

The other part of the growth that we are seeing – that we saw in Q2, really is a continuous glucose monitoring devices, and again, both from Arizona and Dublin. Our production we have to continue to ramp up. We're being asked to produce more volume because the demand is there. And that's very exciting. As we look forward, Dana, we're looking at areas of adding new capabilities from cold chain storage, drug handling. This is also attracting new customers and new projects. So, I believe some of the volatility we are going to have on a positive side, will be to the new offerings that we're going to be offering in the marketplace.

Dana Flanders
Analyst, Goldman Sachs & Co. LLC

Q

Okay, perfect. That's incredibly helpful. And maybe just my second question, on Generics, again, another very nice quarter that you guys have actually accelerating from Q1. Can you just elaborate on the strength there? I mean, is that still Asia-Pac? And maybe talk a little bit about kind of the high-value product growth you're seeing in Generics? What products, what customers, and how you think about just the balance of that as we get into the second half? Thank you.

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

A

Yeah, no, thank you, Dana, It's really – I'm really pleased with the Generics team. I mean, obviously, if you look back to 2017, we had some challenges. And I truly believe based on interactions with customers that was driven primarily due to our inability to have shorter lead times for our customers in 2016. So we had a tremendous volume growth in 2016, 2017 customers gained confidence of our lead times are now well below – you talk about 8 weeks or 10 weeks versus 20 weeks to 30 weeks and have significant – we're getting accolades from our customers now and that's changing the order patterns.

So if you look at the growth we're seeing now, we think we have normalized when it comes to that inventory management cycle. And we are seeing growth across all customer types, large, midsize and small. Let's take this part a little. One is, in Asia, that business continues to grow very fast well in the double digits that we saw in Q1. We're also seeing high-value products growth in Generics continue to ramp up, probably a little bit faster than we anticipated, but it's a good sign that program likes AccelTRA, and our Westar RU and Envision is gaining traction in that particular space. So it's across multiple customer segments. It's not just one or two customers, which I am pleased about. And it is across all geographies, and it's really hitting more of our high-value products and standard products.

Dana Flanders
Analyst, Goldman Sachs & Co. LLC

Q

Great. Thank you.

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

A

Great. Thanks.

Operator: Thank you. Our next question comes from the line of Larry Solow with CJS Securities. Your line is now open.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Thank you. Good morning. Just, first off, I would just like to congratulate Bill – I'm not sure if he's on the call – but his retirement and thank him for the help through the years, and certainly wish him the best of luck, and of course, also welcome Bernard to the team. And I look forward to working with you.

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

A

Great. I know Bill is listening to you. So, that's great.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Thank you. Excellent. Eric, you mentioned just on – I just have a few global questions, most of my questions are answered, but on the high-value products sort of sustainable high-single, low-double digit growth, is it historically or up until today, it's been mostly driven by newly-approved drugs. Are you seeing more or do you expect more sort of an uptick on conversion to some of the older legacy products in customers' pipelines?

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

A

Yeah, Larry, you're right in regards to new product pipeline, particularly in all three market units, we're focused on converting our customers and having focused on high-value products as they go through the process for approval. But we're actually seeing good traction and conversion from standard to high-value products. And in addition to that, we are seeing – I don't want to use the word upgrades to Westar and Envision upgrades than from the standard products. So it's not just moving to the high-value products, we are also seeing our customers move up the value curve all the way up to our NovaPure, and that's one of the elements that you see with that growth. Again, every time we are able to take our customer in a journey towards the – ultimately to the NovaPure offering, not just the ASP increases, it's also the margins increase associated to that. So it's a combination of both, Larry.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Right. And second, sort of, with the product offering, can you maybe just give us a little more color on the new Westar Select, sort of, the incremental benefit it provides? I know, you mentioned, I guess, a tighter particular specification. But is that sort of the incremental benefit? And I guess, sort of expected cadence of growth in benefit? I imagine it'll be a slow incremental growth, constant over time like many of your other products?

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

A

Yeah, no, it's a good question, because the thesis behind this product portfolio is starting to look at our operations from more of a process perspective than the site specifics. So, one of the conversations we had historically is how do we start offering one DMF or Drug Master File for regulatory approval that crosses multiple sites. And you can imagine the benefit for our customers, but also for us, from an operational perspective, that weakens our level loading our operations. This is a journey, and it's going to take some time to convert more customers towards that, but that was really one of the fundamental thesis around the state-of-the-art facility we built in Waterford. So you're going to have customers looking at Kinston, Waterford, and Singapore, and these approvals are made on process and not site-specific, which is a great opportunity.

We also took the opportunity to improve on the formulation and the processes we put in place around the product to really drive the tighter tolerance around specifications. And you can imagine that resonates very well with our customers. So, it is a journey. It's going to take some time to adopt customers into the Westar Select, but this is a change that customers have been asking for a while, and now we have the capabilities of doing it.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Okay, great. And just lastly on the CapEx number, it looks like you lowered numbers by $20 million to $30 million. Just a few questions on that. Obviously, it sounds like it's a positive thing and sort of relate to the successful management of the infrastructure. A couple of questions. Is this sort of a sustainable number as we look out over the next few years? You have any visibility on that? I assume this will sort of – should help. It's probably already helping your operating margin. And is it sort of tied into the whole ongoing restructuring initiatives, where I think you said you expect $8 million to $13 million savings by the end of next year?

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

Yeah. So when we look at the capital expenditures, in the last several years, we had some significant spend on infrastructure. And while we feel really confident that we're going to be able to leverage these new assets, i.e. the expansion in Kinston, the new facility in Waterford, we believe, fundamentally, with the new global operations approach that we can leverage our assets more effectively. We did reduce our guidance for this quarter and we'll continue to assess because the traction has been very positive over the last few quarters. And we'll be able to be a little bit more clear on our expectations going forward for the next few years probably later this year. But my expectations is, we need to drive higher utilization of our existing assets to improve upon not just our margins, but our ROIC and other key metrics that is a clear indicator of the performance of the company.

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

Excellent. Great. Thanks, Eric. Appreciate it.

Eric Mark 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 de Bruin from Bank of America. Your line is now open.

Derik de Bruin
Analyst, Bank of America Merrill Lynch
Q

Hi. Good morning, and welcome, Bernard.

Bernard J. Birkett
Chief Financial Officer, Treasurer & Senior VP, West Pharmaceutical Services, Inc.
A

Thank you.

Derik de Bruin
Analyst, Bank of America Merrill Lynch
Q

Hey, I'm a better molecular biologist than I'm an accountant, so I need a bit of clarification on a couple of points. Specifically, with the 606 related pulling forward of the revenue recognition, so do I take this is that you're now recognizing revenues when they reach a certain level of completion versus being shipped? And I guess, does this mean you can hold products for customers at your facility and still basically recognize the revenues for them? And if so, doesn't that cause like a spike up in working capital?

Bernard J. Birkett
Chief Financial Officer, Treasurer & Senior VP, West Pharmaceutical Services, Inc.
A

Yeah. That's what we talked about is when we looked at our DSOs, we said that our receivable balance had gone up, and a part of that was down to changes in rev rec. And it's primarily, we can recognize a product when it's finished, but that primarily relates to our Contract Manufacture business.

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

A

Yeah. So let me add to this, Derik, it's a good question, because in our Contract Manufacturing business, if you had a chance to visit our site, you'll realize that once we produce product, once it comes off the line, they are transported to our customer immediately, whether it's that day or day after, the day after that. We don't hold the inventory in Contract Manufacturing. And that's how we've established the contracts with our customers.

In the Proprietary business, we are really make-to-order concept. We have very little inventory on hand. And actually, in addition to that, we don't really have any agreements that transfer titles to our customers at that point of time. So, to really be clear on it, it's really in the Contract Manufacturing business, but we are not holding inventory. We are shipping as soon as we have it produced.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks for the clarification. And unless I missed it, did you reiterate the 6% to 8% organic revenue growth guide for 2018? And if so, where on the spectrum are you now looking at it, given you're running 6% for the first half of the year?

Bernard J. Birkett
Chief Financial Officer, Treasurer & Senior VP, West Pharmaceutical Services, Inc.

A

Yes. We reiterated that and we're looking at the midpoint.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Okay. And can you talk a little bit about – I mean, I know some people asked this, I just want a little bit more clarity. Can you quantify the impact on the quarter to the initial stocking orders and the low margin tooling sales on an organic revenue basis?

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

A

The tooling for Q2 was relatively consistent to the Q2 of last year, except for about $2 million. So, that's the delta. We do have $2 million almost on a quarterly basis, but the delta for Q2 is about $2 million.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Okay. And the stocking orders, I mean, is that a pull-forward from the [indiscernible] (44:51)...

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

A

No stocking orders.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

No stocking...

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

A

No stocking orders. I mean, to be clear, there was an increase in demand from our customers to increase volume through our facilities, because their demand to their end markets are increasing. We started – to give you an example, with some of the products in Dublin, we started this journey with a customer and utilization of the existing equipment, because it's a ramp-up process, we're not at full capacity. So we do have the ability to put more product to existing assets, which we're currently working on, because we're not going from zero to 100 within the first couple of months. It's been several months. We do believe by the end of the year, we will be pretty much full – full tilt on the current assets.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Great. That's helpful. And just one final question. You changed your pension accounting, which is – looks like it's a little bit of a net benefit to the second quarter versus the old way. What are the 3Q 2017 and 4Q 2017 op margins under the new method, so we can better model the year-over-year comps?

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

A

Give us a second here. One moment. Do we have it? So it is about – the total value was about $700,000.

Bernard J. Birkett
Chief Financial Officer, Treasurer & Senior VP, West Pharmaceutical Services, Inc.

A

Per quarter.

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

A

Per quarter.

Bernard J. Birkett
Chief Financial Officer, Treasurer & Senior VP, West Pharmaceutical Services, Inc.

A

Yeah.

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

A

So that gives you a feeling of the impact of the pension accounting rules.

Derik de Bruin
Analyst, Bank of America Merrill Lynch

Q

Great. Thanks.

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

A

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Christopher Hillary with Roubaix. Your line is now open.

Christopher Edmund Hillary
Analyst, Roubaix Capital LLC

Q

Hi, good morning.

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

A

Good morning, Chris.

Christopher Edmund Hillary
Analyst, Roubaix Capital LLC

Q

I just wanted to ask we're finally in a clearly inflationary environment and how do you see your business handling that?

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

A

Yes, there is two way to look at it. One is, in our Contract Manufacturing business, we do have agreements with our customers that when raw materials increase, escalate, we're able to pass it on to our customers. So when we look at net price contribution for our business, that really is, from a Proprietary perspective, because it's somewhat neutral when it comes to our Contract Manufacturing. In the Proprietary business, we have hedging programs put in place for our key raw materials, and we also do adjust our prices on a regular basis to accommodate inflations that we may occur whether from raw materials or others costs that we incur. So that's the extent that we see at this point to our business. We have the ability to pass-through in appropriate ways.

Christopher Edmund Hillary
Analyst, Roubaix Capital LLC

Q

Okay. And then maybe just one other one, you talked a lot today. Thank you about the high-value products and the growth that you're seeing there? Are there any products you'd highlight that you think will be either new or driving the growth in the next sort of one to three years?

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

A

Yeah, no, absolutely. So within the high-value product portfolio, we are launching – it's a journey. So if you start thinking about NovaPure, which is the highest quality, Quality by Design product portfolio within high-value products. We are seeing really good penetration there, very high growth there, again, the small base, but this tends to be more in the pipeline molecules for new approvals. And we anticipate over the next several years for that to continue grow. We also have a conversion towards Westar Select to leverage our corporations that we invested in, both Kinston and Waterford. And that would also be a journey over the next couple of years.

I'm very pleased on the initial response by our Generics customers with AccelTRA. We launched that less than a year ago, but the number of samples and customers are going through stability and approval processes gives us confidence that the whole value proposition is resonating with our customers, and you'll see more conversion towards AccelTRA, again, a high-value product portfolio.

And the last one, I just want to talk about is the devices side where SelfDose, that's early into the marketplace. And we were able to launch as a combination with one of our customers combination device. And we're seeing positive response by other customers, and we believe next 12 months to 18 months will have one or two more to share with you with the adoption of SelfDose. So I believe there's multiple opportunities for West to continue to drive new innovations into the marketplace. And it's a common theme here though, we're pushing up on the value proposition so that we can continue to drive market expansion through the mix shift.

Christopher Edmund Hillary
Analyst, Roubaix Capital LLC

Q

Great. Thank you very much.

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

A

Great. Thanks for your question.

Operator: We have no further questions at this time. I would now like to turn the call back to Quintin Lai for any further remarks.

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

Thank you, Sara. And thank you, everyone, for joining us on today's conference call. An online archive of the broadcast will be available on our website at www.westpharma.com. Additionally, you may access the telephone replay through Thursday, August 2nd, by dialing the numbers and conference ID provided at the end of today's earnings release. This concludes the call for today. Have a nice day. Bye.

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