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West Pharmaceutical Services, Inc. (WST)

Q4 2016 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the West Pharmaceutical Services Q4 2016 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 follow at that time. [Operator Instructions] As a reminder today's conference call is being recorded.

I would now like to turn the conference over to Quintin Lai, Vice President of Investor Relations. Please go ahead.

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

Thank you, Candice. Good morning, and welcome to West's fourth quarter and full year 2016 conference call. We issued our financial results this morning, and the release has been posted in the Investor section on the company's website located at www.westpharma.com.

This morning CEO Eric Green and CFO Bill Federici will review our results, give you an update on our business, and provide a financial outlook for the full year 2017. There's a slide presentation that accompanies today's conference call, and a copy of that presentation is also available on the Investor section of our website.

On slide two is the Safe Harbor statement. Statements made by the management on this call and in the presentation contain forward-looking statements within the meaning of U.S. Federal Securities Law. These statements are based on management's beliefs and assumptions, current expectations, estimates and forecasts. There are many factors that can influence the company's future results that are beyond the ability of the company to control or predict.

Because of these known or unknown risk or uncertainties, actual results could differ materially from past results and those expressed or implied in any forward-looking statements. 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, operating – 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?

Eric Mark Green

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

Great. Thank you, Quintin, and good morning, everyone, and thank you for joining us today. A little more than one year ago we announced a realigned organizational structure to better support our market-led strategy. We did this to heighten our focus on becoming the leader in the integrated containment and delivery of injectable medicines. We shared with you that this was to be a long-term journey to fill growth and profits for West, and I'm pleased to say we are well on our way. We delivered a strong set of results in 2016, and we are poised to continue this growth in 2017.

To recap for you, we reorganized our company into three major groups: Commercial, Global Operations, and Innovation & Technology. Within the Commercial team, we created two segments: Proprietary Products and Contract-Manufactured Products. To ensure alignment with our customers in addressing the specific needs of each, we created the Pharma, Generic, and Biologics market units.

We transitioned away from a recently focused operations to a globally-managed network, expanding capacity and significantly reducing delivery lead times of critical high-value products. At the same time, we raised the bar on our already industry-leading quality metrics and increased our focus on operational efficiencies, which has allowed us to better address the demand of our worldwide customer base.

Under our newly-formed Innovation & Technology team, we continued to build momentum by adding new high-value products to our components business while achieving milestones successes with customer FDA approvals of drugs using Crystal Zenith and SmartDose technologies. And through all this transition, we continue to meet our long-term financial objectives. We ended the year with over 9% organic sales growth, which is above our long-term target of 6% to 8%. We expanded both growth and adjusted operating profit margins and generated strong 19% adjusted diluted EPS despite having a $0.04 FX headwind.

Turning to slide four, when we look at the growth rates over the past years, 2016 stands out as being an impressive year for both organic sales and adjusted EPS growth. We are pleased with our track record of creating incremental shareholder value year-over-year. Today we're laser-focused on executing our long-term strategy, which should enable future growth at the same pace.

Turning to slide five, looking at the year, the Proprietary Products segment represented 79% of total sales with organic sales growth just under 10%. This segment was led by double-digit organic sales growth in Biologics and Generics market units with mid-single-digit growth in our Pharma market unit. Organic sales growth of high-value products was 20% for the year.

Our market-leading position remains strong as we achieved 90% participation on all the new injectable drugs approved by the FDA in 2016. Our end markets remain stable and growing. Demand from our biologics customers was strong and steady throughout the year as we continue to see demand from both large biologics and emerging biologics customers.

Generics' growth for the year was solid, with exceptionally strong sales in the first half of the year offset by a weaker Q4 as some of our large customers manage their inventory in response to our successful reduction in lead time. Some of our Generics customers place very large volume orders which can cause quarter-to-quarter variability. We believe, on a 12-month rolling average, these variabilities typically even out. When we look at our smaller Generics customers, which is over a half of the market unit sales, we have seen a much steadier growth pattern of high-single to low-double digits.

Pharma, which represents some of our largest and most mature customers, delivered steady mid-single-digit growth throughout the year. We see continued opportunities to migrate our Pharma customers from standard component to a high-value product, and we are seeing good traction and synergies between our components business and Contract-Manufacturing.

Our Contract-Manufacturing business, which represented 21% of our total sales, grew organically mid-single digits with double-digit growth in Q4. Much of the Q4 outperformance is related to tooling sales as we are adding equipment on behalf of our customers, and ahead of meaningful high-volume campaigns that will begin later this year. The typical time between installing tooling equipment and commercial volume is about 12 to 18 months, which makes us optimistic about accelerating growth for Contract-Manufacturing as 2017 progresses.

Turning to Global Operations on slide six, the team has had a number of successes in 2016. Recall that our backlog had risen to approximately $450 million in Q1 because we're capacity constrained for certain high-value product lines. Due to our Global Operations' focus on lead times through continuous improvement, the team increased operational efficiencies added capacity to our network. As we ended the year, the backlog has come down to $373 million, an 8% decline at constant currency from 2015 year end levels.

Another area of success has come from the creation of a Global Supply Chain and Procurement organization which is driving cost savings across the business and stronger management of our global supply base.

At the same time, we continue to reinvest in our business for future growth. We recently completed and commissioned a 60,000-square foot expansion of our Dublin, Ireland contract manufacturing facility on time and within budget. I attended the opening in Dublin, and was pleased to hear directly from customers how important the facility will be in helping them prepare for their product launches. Commercial production in Dublin has already begun and will ramp up throughout 2017. And we remain on schedule for the first phase of our Waterford, Ireland site, which will manufacture insulin rubber sheeting. Additionally, we continue to build out high-value product capacities in our other two Centers of Excellence in Kinston, North Carolina, and in Singapore.

Turning to slide seven, 2016 was a year of new product launches by our Innovation & Technology team. Many of these were highlighted during the year. This is a good time to remind you that like many R&D projects, these are the result of years of work behind the scenes. Because our products are used in various medical applications, we conduct extensive and time-consuming testing and validation before any product is launched.

Turning to slide eight, this is a snapshot of our Innovation & Technology pipeline. While we often talk about CZ and SmartDose, the Innovation & Technology team is working on numerous projects that will enhance our entire portfolio with new innovations and product line extensions to address customer needs.

On slide nine, we have outlined our full year 2017 outlook. In October of last year, we set initial 2017 organic sales growth guidance to be at the high end of our long-term range of 6% to 8%. With solid market fundamentals, we are raising our 2017 organic sales growth outlook to a new range of 7% to 9%. As we have noted, we expect strong double-digit high-value product growth. In Generics, we expect a safety stock reduction to dissipate in the first half with an acceleration in the second half, resulting in high-single to low double-digit growth for the full year. Finally, we also expect a shift of sales from tooling to Commercial product and Contact-Manufacturing as the year progresses.

We anticipate another year of strong gross margin expansion with R&D and SG&A providing additional leverage, resulting in an adjusted EPS guidance in the range of $2.45 to $2.57. This represents a 12% to 18% year-over-year growth, and includes a $0.05 to $0.07 EPS headwind from a stronger U.S. dollar. Excluding this impact, EPS is anticipated to grow 15% to 21%, which is twice our anticipated organic sales growth.

Now I turn it over to Bill Federici who will provide more color on our financial performance. Bill?

William J. Federici

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

Thank you, Eric, and good morning, everyone. We issued our fourth quarter results this morning. Excluding the effects of special items from both periods, fourth quarter 2016 earnings was $0.54 per diluted share versus the $0.47 we earned in Q4 2015. The reconciliation of these non-GAAP measures is provided on slides 16 to 19.

Turning to sales, slide 11 shows the components of our consolidated sales increase. All references to sales amounts are to constant currency. Consolidated fourth quarter sales were $382.3 million, an increase of 7.7% over fourth quarter 2015 sales.

Proprietary Products sales were $290 million, a 6.5% increase over the same quarter 2015. A favorable sales mix and volume growth accounted for 6 percentage points of the increase; modestly higher selling prices contributed the remainder of the increase. High-value product sales increased 14% versus the prior year quarter.

For the full year 2016, high-value product sales increased approximately 20% versus 2015. Combined CZ and SmartDose sales and development activity were $27 million for full year 2016, a 10% increase versus the prior year. Contract-Manufactured Products sales were $92.4 million, an 11.6% increase over sales in the prior year quarter due to higher drug delivery and diagnostic product sales, including increased low margin tooling revenues.

As provided on slide 12, our Q4 2016 consolidated gross profit margin is 32.3% versus the 33.3% margin we achieved in the fourth quarter of 2015. Proprietary Products fourth quarter gross margin of 36.9% is 0.4 margin points lower than the 37.3% achieved in the fourth quarter of 2015. A favorable mix of products sold, modest sales price increases, and continuing savings and plant efficiencies were more than offset by the impact of higher general inflationary costs, yen-denominated material purchases which had an unfavorable impact of $2.2 million or $0.02 of EPS headwind in the quarter, and facility start-up costs.

Contract-Manufactured Products fourth quarter gross margin of 17.6% was 2.2 margin points lower than the prior year quarter due to an unfavorable sales mix, mainly from incremental low margin tooling sales and unabsorbed overhead especially in our recently completed Dublin manufacturing facility.

As reflected on slide 13, Q4 2016 consolidated SG&A expense decreased by $1.5 million compared to the prior year quarter. The decrease is due primarily to low achievement levels on incentive comp programs offset by staffing increases and higher stock compensation costs. As a percentage of sales, Q4 2016 SG&A expense was 1.5 percentage points less than the prior year period.

Slide 14 shows our key cash flow metrics. Operating cash flow was $219 million for the full year of 2016, $7 million more than 2015 due primarily to our strong operating results, offset by higher working capital requirements. Capital additions of roughly $170 million were made in 2016. Roughly 60% of the capital spend is on new products and expansion efforts, including approximately $55 million in Waterford and $20 million for our recently completed Dublin Contract-Manufacturing facility. We expect capital additions of between $150 million and $175 million in 2017, including approximately $16 million of cost associated with the new Waterford facility.

Slide 14 also provides some summary balance sheet information. Our balance sheet continues to be strong, and we're confident that our business will provide necessary future liquidity. Our cash balance at year end was $203 million, $72 million lower than our December 2015 balance. Roughly 60% of that cash is invested overseas, and is generally not available for repatriation without tax consequences. The lower tax balance reflects the payment at maturity of our Euro B notes in February of 2016.

Debt at year end was $229 million, $70 million less than the prior year end due to the payment at maturity of our Euro B notes. Our net debt-to-total invested capital ratio at year end was 2.2%, approximately the same as in the prior year end ratio.

Working capital totaled $401 million at year end, $41 million higher than the prior year end due to increases in receivables and inventory balances, reflecting our growing business. Our backlog of committed orders were $373 million as of December 2016, which is approximately 8% lower than our December 2015 balances excluding exchange due to the actions taken to increase capacity and throughput, reducing plant lead times and relieving the backlog.

We have issued our full year 2017 guidance in this morning's release. That guidance is summarized on slide 15. Our guidance is based on an exchange rate of $1.05 per euro. Our actual 2016 results translated at $1.11 per euro rate. Exchange rates will likely continue to be a headwind throughout 2017 due to the strengthening U.S. dollar versus other currencies. Currency volatility in Asia and emerging markets is expected to add headwinds to the business in 2017.

We expect our 2017 effective tax rate to remain at approximately 29%. Our tax rate is highly dependent on the geographic mix of earnings which, driven by sales of high-value products, has been migrating towards higher tax rate jurisdictions like the U.S. which has an adverse effect on our tax rate.

Our 2017 guidance includes a $0.02 EPS benefit resulting from our previously announced 800,000 share repurchase plan. We expect our Q1 2017 margins will continue to be adversely impacted by the effect of currencies including the Venezuelan bolivar, the Brazilian real, the euro, and the Japanese yen; customer inventory management, and plant start-up costs.

We expect a resulting Q1 consolidated operating profit margin of approximately 14.8% to 15%. All of these factors are included in our full year 2017 guidance. With growth accelerating throughout 2017 in our Generics and Contract-Manufacturing market units, we expect a stronger second half of 2017 compared to the first half. We expect to deliver on our full year 2017 earning guidance of $2.45 to $2.57 per diluted share which, on a constant currency basis, represents an increase of between 15% and 21% in diluted EPS over 2016.

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

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

Great. Thank you, Bill. In conclusion, we delivered a strong set of results and made significant progress in executing the first year of our long-term market-led strategy. Our Commercial team is -continues to make deeper inroads with the discrete customer groups we have targeted. Our Global Operations team has a roadmap to improve quality, safety, service, and cost. And our Innovation & Technology team is building a strong pipeline of integrated containment and delivery products to meet customer needs. For these reasons, we believe the future looks bright, and we will continue to deliver long-term value for our customers and shareholders.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from Paul McKnight or Paul Knight of Janney Montgomery. Your line is now open.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

Hi, guys. Can you go over the exact organic growth – excuse me, starting with FX. Could you give me the impact for FY 2016 total and kind of where your thoughts, again, are on the potential impact on 2017?

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

A

Okay. So for 2016, Paul, for the full year the FX was a $0.04 negative hit to us. For 2017, we expect to see continued headwinds from currencies. The euro has declined; the dollar has strengthened against that and against Asian and South American currencies. So we expect to see a $0.05 to $0.07 reduction adverse headwind from currency in 2017.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

And then your op margin, the guidance for Q1, was what, Bill?

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

A

14.8% to 15%. That's consolidated operating profit margin.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

And then lastly regarding Ireland win. Will we see any revenue contribution from that capacity expansion here in 2017?

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

A

Yeah. In regards to Waterford and the Phase 1 of the insulin sheeting, we are in process towards the end of 2017 to validate with our customers, and the commercial revenues will be observed in the first part of 2018. On the Dublin contract manufacturing facility, we've started-up and we'll start seeing commercial revenues ramp-up throughout the year for the three customers.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

And then lastly, Eric. Can you talk about what you're seeing with projects in Phase 3 or projects with Crystal Zenith? Tone of market for your Proprietary Product line?

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

A

Yes. Paul, there's really two ways of looking at it. One is, let's start with the high-value product portfolio or on our elastomers and seals. We continue to see very healthy conversion of going from standard packaging up to high-value products. And in addition to we're seeing new molecules, which is exhibited in the 2016 injectable drugs that were approved; were on 90% of those. And so we're seeing a very nice uptick continuing in our high-value products. That said, the Innovation team has continued to expand the portfolio and raising the capabilities, so new formulas, new processing technology to raise the quality standards, which obviously is boding well with our customers today.

When we look at – on the CZ and SmartDose or in self-injection devices, we've seen in both situations, both of those product lines, an increase of number of developments. So in SmartDose, there's a slight increase on the number of developments with customers, and there's more conversations going on today than we've had over a year ago; and then on the CZ, there's increase in form of stability. So we're still very pleased with the progress, although it's timing with our customers. We still see those two platforms very strong viable growth long-term.

Paul Richard Knight
Analyst, Janney Montgomery Scott LLC

Q

Thank you.

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

A

Thank you.

Operator: Thank you. And our next question comes from Tim Evans of Wells Fargo. Your line is now open.

Sara Silverman
Analyst, Wells Fargo Securities LLC

Q

Hi. This is Sara Silverman on for Tim. Just a couple for you, guys. I wanted to follow-up on the FX guidance. We had tried to model the FX impact on EPS pretty carefully for 2017 but it still looks like we kind of undercalled the headwind. Can you help us understand the FX mix in your cost base, particularly a little more details on the yen and euro, and then any of those other currencies that are pretty impactful?

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

A

Sure. So, Sara, the euro versus dollar; everybody knows that one. When we talked to you last at the end of October, it's hovering right around $1.10 per euro. Now we've guided her,e for the full year our view of it is that it's leaning at that $1.05. Now obviously that'll change, but we had to put a stake in the ground somewhere, so we put it at $1.05 per euro.

On the other pieces of the puzzle, certainly in Asia where we sell out of our Singapore facility in both dollars and euros, we're seeing the impact of the strengthening dollar there as well. And in South America, we're seeing the volatility of those currencies continue, and that will continue to provide a headwind for us. In addition to the fact that we still have an investment in Venezuela, and we know the situation there, should there be another official devaluation, we have an exposure of somewhere between $5 million and $7 million depending on what they devalue the business to.

So those are the primary drivers, Sara. I mean, there's a lot involved in this obviously and we're a very global business with operations all over the place, but those are the primary drivers.

Sara Silverman
Analyst, Wells Fargo Securities LLC

Q

Okay. In terms of like percent of your cost base, do you have an idea like how much is euros, how much is yen?

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

A

I could give you on the sales and then you can convert that, but it's not perfect. So on the sales for 2016, we were 40%, basically euro-based; and Asian and Latin and South American businesses were approximately in order of magnitude of 10%.

Sara Silverman
Analyst, Wells Fargo Securities LLC

Q

Okay. And then just another one on guidance. You guys took up of your constant currency revenue growth guidance. Can you kind of elaborate on the factors that gave you confidence around that, to raise the guidance this early in the year kind of considering it's a bit second half-loaded?

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

A

Yes, Sara. No, when we take a look at what we've accomplished in 2016, looking at the pending order list that we have with our customers and also the investments we made in certain parts of our business, we feel really strong with the 7% to 9%. To kind of dimension this a little bit our Pharma business, we believe that will continue with mid-single growth, and obviously we delivered that in 2016.

In the Generics business, while there is some lumpiness with our top customers, this – and I mentioned earlier that smaller customers in Generics are a little over 50%, but, really, about a third of our business are five large Generics, and we have clear visibility on their stocking, and they are actually moving up the high-value product curve. And the strength of our operations, reducing lead times by 2x, has given us the confidence to continue to stay at high-single, low-double in that business.

Biologics, we're seeing continued strength around double-digit consistently. And then Contract-Manufactured is one that in 2016 we're about mid-single, but with the investments we made we're ramping-up to the high-single throughout 2017. If you add all that up, it's between – we're very comfortable with the 7% to 9% organic.

Sara Silverman
Analyst, Wells Fargo Securities LLC

Q

Okay. Just to clarify kind of – if you had to pinpoint what kind of push the needle from October to, say, now, would you pinpoint one thing or is it kind of generally broader growth than you had previously anticipated?

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

A

Yeah. I would say one is the uptick on the conversations we're having with the Generics. And as we talk about the – our innovation platform, we're already looking at potentially new formulas for them that will allow us to compete more in the high-value products and do the switching. It's a little bit a type of – that's the difference between, I would say, in October than what we are today.

Sara Silverman
Analyst, Wells Fargo Securities LLC

Q

Okay. Thanks, guys, so much.

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

A

Thanks, Sara.

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

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Good morning, guys.

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

A

Hi, Larry.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Just couple of quick follow-ups. Just on the sort of back end-loaded outlook. Obviously backlog was down 8%, I guess, year-over-year and that's obviously what you got us to your motivation, what you want to do, so clearly that was a little bit higher, and you mentioned some customer change in the order patterns or inventory patterns. Is that sort of part of the reason for the back end-loaded outlook? Can we expect some adjustment? I know you had some adjustment on your Generics customers this quarter and it looks like you expect some of that to happen on the Biologics side as well?

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

A

Yeah. When we look back in Q4, we knew- we've talked our Generics customers. We knew that because of the success we have in reducing lead times that there was going to be a reduction on the safety stock in their own manufacturing facilities and, therefore, we had that anticipated in, really, first half of 2017 but that was brought forward a little bit earlier than we anticipated in the latter part of Q4. So that is one of the drivers that we see – the reason why you're seeing a little bit stronger growth in the second half of 2017 than the first half.

The other is, as I mentioned earlier, about the Contract-Manufacturing. Some of the investments we made in the tooling and getting our sites up and running are in the ramp-up phase at this point, and that's what's bringing it from the mid-single to the high-single. And, again, a lot of that's going to the back half of the year.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Got it. And then just – and you mentioned tooling and the investments in that side of the business. Just in terms of gross margin, obviously your outlook is for pretty nice improvements, 120 basis points to 160 basis points. It looks like 2016 was a little more impacted than we thought, particularly in Q4 from some of the start-up costs. The improvement going forward, it sounds like – and you're continuing to get the expansion from the better mix. And then, I guess, your conversion to more of a Commercial from the tooling and lower, I guess, start-up costs. So those were the factors that'll drive the expansion this year?

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

A

Yeah, Larry, absolutely. Two things: one is, specifically on Contract-Manufacturing, is that we anticipate lower levels of tooling revenues in 2017 than we did in 2016. That was a little bit unusually higher for us, and it's all included mostly in the Q4 time period. I think also with the ramp-up we have with our Generics and moving more towards the high-value products, as you know our high-value products are almost 2x on the gross margin than our standard products. And we still see very strong double-digit growth in high-value products, and that's the major driver of this shift.

Bill, do you want to add some color to that?

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

A

Yeah. On the Contract-Manufacturing side, Larry, the tooling revenues are very, very low margin as we suggested. So that mix shift from – but the good news is it's a foreshadowing of commercial business coming through on Contract-Manufacturing. Those customers are ready, we're starting to provide them products. So Q1 – starting in Q1 and rolling through 2017, we'll be replacing tooling revenues with margin – good margin revenues in Contract-Manufacturing.

So, yes, it did absolutely hurt us, that tooling piece. It was about $6.5 million of extra tooling revenues in the fourth quarter of 2016 which hurt us to the tune of 1.2 margin points in Contract-Manufacturing. So we expect to be – the mix shift potentially starts to come with those new customers to really bring us up on the margin scale for Contract-Manufacturing throughout 2017.

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

Got you. And then it looks like price helped you benefit – you guys benefit a little bit on the quarter, 0.5% or so. What's the depth of the benefit for the full year, and going forward do you expect, maybe, to the benefits to increase on the pricing front?

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

Larry, we, and historically in the last several years, have been roughly around 1% price contribution in our business. I would say in 2016 we're slightly less than that at this point. And as we look into 2017, we believe we'll still continue to be around that 1% plus or minus slightly but not a significant deviation from what we've seen over the last two or three years.

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

Got you. The CZ/SmartDose total number, did you say that was $27 million?

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

$27 million, Larry. Yes, a 10% increase on a constant currency basis over $26 million.

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

Got it. It was sort of closer to flat I guess on a reported basis or [indiscernible] (34:49)?

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

On a reported basis it's flat, but when you take out currency it's about 10% up.

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

That sounds pretty. And then the – so I guess sort of I know we had expected some sort of a decent amount more growth. Obviously it's a small number, so the percentages get a little skewed. But was that slower on the SmartDose side, CZ side, both? Any color there would be great.

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

Yeah. It's just two elements, that one is the development agreements that we were working on in the later part of 2016; I'll look into – implement more in the early 2017 timeframe. The second is around commercial ramp-up, working with our customers, and we have pretty clear line of sight, but that is going to be pushed more into the early 2017 than late 2016.

So those are the two elements that really drove that 10% growth. It's a little bit higher than we anticipated.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

So it sounds like more timing than anything else?

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

A

Yes, Larry. It's a timing factor.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Great. And then just last one on the tax rate. Obviously hovering or slowly creeping up towards 29%, sort of a high class problem. But as you look out going forward, excluding any potential corporate tax overhaul in the U.S., and who knows what's going to happen there, but as you shift more into Ireland and whatnot, do you expect this rate to maybe at least stop going up and then over time hopefully coming down a little bit?

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

A

Absolutely, Larry, but you got to be patient with these things. As you know, our business, we're not expecting any real growth coming out of Waterford in 2017; it really doesn't start commercial until early part of 2018. We'll get some benefit out of Contract-Manufacturing; and Dublin, more activity there and more sales there. But it's that 20% margin as opposed to the high 55% high-value product margins we expect out of Waterford.

So, yes, the answer, the long-term answer is absolutely, we believe that we can drive our – we think we could drive our effective tax rate south. But to be honest, in the interim, as we continue to sell more and more high-value products in the U.S. and other high tax jurisdiction countries, there's going to be upward pressure on that rate. I don't expect it to move a lot during 2017, but I wouldn't be expecting a significant decline in 2017.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Got it. Great. Okay. Thanks a lot, guys. Appreciate it.

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

A

Thank you, Larry.

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

A

Thanks, Larry.

Operator: Thank you. [Operator Instructions] And our next question comes from Derik de Bruin of Bank of America. Your line is now open.

Juan Esteban Avendano
Analyst, Bank of America Merrill Lynch

Q

Hi. Good morning. This is Juan Avendano on behalf of Derik.

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

A

Hi, Juan.

Juan Esteban Avendano
Analyst, Bank of America Merrill Lynch

Q

Hi. I wanted to start out – you used to provide gross margin guidance by segment. Just curious as to why you stopped doing that this quarter?

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

A

Honestly, what we're trying to do is just provide – be transparent and we believe that the business, the way the business has evolved into these market units, it's more effective to talk about it the way we are.

Juan Esteban Avendano
Analyst, Bank of America Merrill Lynch

Q

Okay. Good. On the adjusted operating margin, what should we expect for 2017? Just curious what the contribution may be from any SG&A or R&D leverage.

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

A

So I'm not clear on the question, Juan. Do you mean for the whole year or you're just talking – we only gave – we talked about Q1 and we also gave some guidance as it relates to the full year on consolidated gross margin. So...

Juan Esteban Avendano
Analyst, Bank of America Merrill Lynch

Q

I'm talking about the operating margin full year.

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

A

So from a leverage perspective, yes, absolutely, we expect leverage to come from both SG&A and R&D, so our operating profit margin will be – expansion will be greater than our gross profit margin expansion.

Juan Esteban Avendano
Analyst, Bank of America Merrill Lynch

Q

Okay. And my next question is on the Contract sales segment. And so you're guiding for high-single digit organic growth this year? This is above your long-term outlook for the segment, which is mid-single digit. Is this a 2017-only phenomenon or are you changing – or do you still expect a mid-single digit in the long-term for Contract-Manufacturing?

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

A

Yeah. Juan, at this point, when we take a look at the business, 2017 is really a ramp up of the investments made in 2016. And just to give a little more granularity, this is really focused in the diabetes market, on delivery devices, whether it's insulin pens or even continuous glucose monitoring devices. And as it's the ramp-up phase, we'll see a higher impact on the 8% growth rate in 2017. We anticipate that to kind of level back to mid-single long-term as what we see with the markets today; it's slightly better than the market. So that's what we're looking at. It's more of a 2017 ramp-up.

Juan Esteban Avendano
Analyst, Bank of America Merrill Lynch

Q

Okay. Good. And one of your – just recently at the end of last year, one of your competitors and also customers had their Analyst Day, and it seems like they're focusing a lot more in the self-injection market. They plan to launch a product every year, with one particular product being launched this year in the diabetes market. What opportunities or challenges does this present to West?

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

A

Yeah. I think when we look at the diabetes market, you're right, when we look at the primarily containment or the – of where we sit with our elastomer business, we're basically on all the formats for the delivery devices. When it comes to device itself, for Contract-Manufacturing there are a number of players, especially when you start talking about wearables; it's a very early stage at this point. But we feel good about where we are. We are a critical supplier partner with the large insulin manufacturers.

We also have connectivity to other firms who are looking at this space from a device perspective. So you're right, there's a number of competitors who are looking at it because of the attractive growth, but we're already in the market, we're expanding the market, we're adding new products that'll support the growth of our customers.

Juan Esteban Avendano
Analyst, Bank of America Merrill Lynch

Q

Okay. And lastly, similar to the pricing question before, based on my calculations you got about 70 basis points of pricing in 2016, slightly below the usual 1% typically year-over-year. Are you seeing any pressure at all, given the – cascading down from the biopharma drug pricing scrutiny?

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

A

No. I would say that at this point it's pretty consistent to what we have been seeing obviously with the products that have been in the drug market for a number of years, maybe over a decade, may have more pressure on the standard packaging components. But when we look at the high-value products and the devices, we obviously have continued runway to capture the bulk of approximately 1% per annum. So we're pretty comfortable with that.

Juan Esteban Avendano
Analyst, Bank of America Merrill Lynch

Q

Okay. Thank you.

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

A

Thanks, Juan.

Operator: Thank you. And that concludes our question-and-answer session. I'd now like to turn the conference over to Quintin Lai for closing remarks.

Quintin John Lai

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

Thank you, Candice. Thank you for joining us in today's conference call. An online archive of the broadcast will be available on our website at westpharma.com, in the Investors section. Additionally, you can get a telephone replay through Thursday, February 23, by dialing the numbers and conference ID provided at the end of today's earnings release.

That concludes today's call. Have a nice day.

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