09-Jun-2022

West Pharmaceutical Services, Inc. (WST)

Jefferies Healthcare Conference

CORPORATE PARTICIPANTS

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

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

OTHER PARTICIPANTS

David Windley
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

David Windley
Analyst, Jefferies LLC

All right. Welcome, everybody. I'm Dave Windley with Jefferies Healthcare Equity Research. Glad to be here after [indiscernible] (00:00:08). It's great to see everybody and glad we could be in person for our New York Healthcare Conference here in June of 2022.

I'm very pleased to have with us, for our next presentation or fireside chat session, West Pharmaceutical Services. The company is a leading player in the containment of injectable drug products, and representing the company is the company's CFO, Bernard Birkett; and the Head of IR, Quintin Lai. So, thank you, gentlemen, for being here with us.

QUESTION AND ANSWER SECTION

David Windley
Analyst, Jefferies LLC

Q

I'm going to fire off, just dig right in to questions. Bernard, your high-value product is – high-value products and your transition to those has really been a theme for the company for a long time. But in the last maybe two or three years, the contraction of those or the inflection of those seems to have kind of taken on a life of its own, almost. So, maybe you could talk about the drivers of demand for high-value but, particularly, where you're seeing kind of the upsell into the highest of high-value, your FluroTec and NovaPure products.

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

A

Okay. Good afternoon. And, first of all, thank you, Dave, for the invite here today. It's been a very busy day for us meeting with a lot of various investors, and it's been very productive. So, thank you for that.

Yeah. On the high-value products, I think that you got to go back probably to 2015, 2016, when we looked at the structure of our organization and really put three market units in place: Biologics, Generics, and Pharma. And that give us a lot of focus as to how to really understand what our customers need is and really to target those specific areas. And obviously, Biologics was one of the key areas for us because that's where we really sell a lot of our high-value products, and that's an area where customers are demanding that type of product.

And what we've seen, that we have been gaining traction over the last number of years and I think in 2018, 2019, we were starting to get there and we were – particularly, we were seeing uptake in our NovaPure product offering in and around 2019. And since then, as we've gone through 2020 and 2021, both from a – responding to COVID vaccines and supporting those drugs getting to market, and also really with the strong growth within our core Biologics market segment, we've seen a really strong uptake where the Biologics business has gone from probably just north of 20% of our business to 42% of our business right now.

A lot of that is really driven by uptake on new molecules, particularly when we're looking at the NovaPure product platform, which is now really the go-to choice for many of our customers, and also the growth that we're seeing in our FluroTec range of products. And what we're also seeing is, there are some customers who are transferring from standard products to products like Westar. So, we are seeing some traction there as well. But again, it's mostly driven by Biologics where we have a very high participation rate in that segment.

David Windley
Analyst, Jefferies LLC

Q

That's excellent. So, a couple of follow-ups there. So, as you think about the selection of high-value product, in some cases, I've thought that maybe the product itself, the drug substance that is going into that container might dictate the appropriate container for it to go in, be it siliconization or things like low silicon content or friction elements or things like that. But for customers to buy up to NovaPure and just kind of go straight to the highest-value product suggests a different set of drivers, perhaps. Maybe you could talk about why the client is kind of pushing to the highest of the high-value, what's that driver?

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

A

Well, I – when we look at it, and we're helping our customers select what product to look for, particularly at the higher end. And when you look at the cost of many biologic drugs, they're really looking for the best product possible to take as much risk off the table and at the highest levels of quality to make sure that they have no issue when they go to market.

So, that takes them to NovaPure essentially straight out of the gate in many cases. They can see the benefits of that product and the various attributes it brings and the risk it actually takes off for them. And that's the same – in my mind, that's why they go for it. But I don't know, Quintin, if you've anything to add to that?

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

Dave, you bring up a good point. Biocompatibility is always paramount for drug companies as they're trying to select their primary package. And in the case of some of the drugs that are coming out now that are large molecule, they happen to be extremely sensitive to particulates or extractables and leachables, which then pushes the selection toward a coated product like FluroTec.

And then, when you then start to take a look at, as Bernard said, the costs of the product, and if you think about the cost of goods of just the API itself, having to throw away product in case that there is a contamination issue, opening up the chance for recall, all of those things weigh into the decision of just saying, look, I want to go – not only I want to take something that's biocompatible but I also want to take the highest quality product; and NovaPure, because of our process of quality by design, where we're looking at every step of the manufacturing along the way, gives them that quality assurance and better yield.

David Windley
Analyst, Jefferies LLC
Q

Got it. Okay. Another point here before I leave this particular topic is the – that has been interesting to me is the seemingly universal move, COVID products, non-COVID products. I guess, it's mostly in Biologics as you highlight that that has grown a lot, but that it really has been a broad move, not a narrow selective move but a broad move to NovaPure. And so, maybe you can – could touch on the COVID versus non-COVID elements of the growth a little bit?

Bernard J. Birkett
Senior Vice President & Chief Financial Officer, West Pharmaceutical Services, Inc.
A

Yeah. On the COVID response we had, there was a large uptake around NovaPure and also around FluroTec. So, we're using both technologies and some standard product. But it goes back to what we've already mentioned. It's when you're trying to get a drug to market quickly, you want to take as much risk off the table, have the highest quality product so you can make sure you get to market with the highest levels of security. And I think that's what NovaPure brings and guarantees for the customers.

And again, as you look at it as a percentage of COGS, as Quintin mentioned, it's a pretty small amount. It's typically less than 1% to 2% of COGS. So, for a small amount of expense, you're taking a lot of risk off the table. And that's what we've seen particularly on the COVID and this response and the speed that was needed. And then when you look at the non-COVID business, again, it's matching it up with the drug. And, again, Biologics drugs are calling for the highest levels of quality to reduce all of the risk factors that Quintin mentioned.

And so, it's similar in both areas. But again, it's – when you look at it, what you get for using our highest product, you take so much risk off the table, and you are getting the highest levels of quality for a small cost in relation to the drug.

David Windley
Analyst, Jefferies LLC

Q

Let's – while we're on this, let's flip to the capacity side of this topic. So, you've announced several fairly substantial CapEx investments pulled forward, some CapEx investment in adding capacity in high-value. You've emphasized the point that this is essentially on the critical path of your long-term plan, just kind of advances the timing of that. Do you have enough capacity in place in FluroTec and NovaPure to serve the demand that you see coming into your sales funnel?

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

A

Well, yeah, so we've been layering in extra capacity since 2020. And as you say, it is particularly around FluroTec and NovaPure, and that's where a lot of our growth investments have been going and will continue to go as we progress through 2022, 2023, and into early 2024.

COVID actually accelerated the demand that we had seen, and we had been building the capacity. Much of the capacity that we accelerated was built into our five-year plan originally. But with this sudden acceleration where we saw the uptake around COVID products and then really strong growth – core growth within our Biologics unit, it has put or challenged to us into meeting the demands of our customers.

And what we have seen is that our lead times have extended around some of these products, and we've had to be selective and prioritize where we have been supplying to customers, making sure that we're meeting their near-term demands and making sure that we're not stocking anybody out, [ph] and we think (00:10:17) we have managed to do that. It has been challenging for us and it – that – we see those challenges continuing for at least through 2022, and so we layer in this extra capacity.

David Windley
Analyst, Jefferies LLC

Q

Got it. Before we leave the COVID topic, there were some shifting sands in the first quarter when we talked. At that time, you talked about maybe some orders that got cancelled, some that were just deferred later into the year. Can you give us a sense of the firmness of your covered book at this point? How much confidence do you have in that and to what extent do you have visibility in this kind of long awaited shift in format?

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

A

Yeah. So it's – in our initial guidance back in February, we had initially expected COVID revenues to grow approximately in the mid-teens, in line with our core business. And then, when we did our guidance after our Q – on our Q1 call, we had to reassess that. And now, we're seeing our COVID revenues probably grow in the single digit range. But to offset that, we've seen a pickup in our core business. Again, particularly within Biologics, so we're actually able to reaffirm our guidance, essentially raise it as we were absorbing more FX headwinds.

So, again, it's like a – it is a moving target. It's something that we're watching very, very closely. We have still a strong demand and orders in our books for COVID products. And – but it's something that we are watching with our customers and really trying to understand their forecasts as we progress through 2022 and into 2023.

And also understanding, from a delivery point of view, are we still going to be supplying in vials of 10 to 14 doses or will there be a switch to vial – to 1 to 3 doses per vial and, at some stage, possibly looking at prefilled syringes? So, there's a number of dynamics that are playing into this, and we're running a number of different scenarios, but it is like a moving target.

David Windley
Analyst, Jefferies LLC

Q

Yes. Thank you for that. That's very helpful. On that last part, it does sound like that's still, as you said, a moving target, still somewhat uncertain in terms of the shift in format. I guess, [indiscernible] (00:12:42) – Quintin knows this, in the equity markets we have attention spans of five minutes. So, we think the world revolves in 30 seconds or something, but what's the holdup there, I guess, essentially?

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

A

Well, I don't know if there's a holdup. I think the vaccine providers have to decide the appropriate time as to when they want to make that shift. And I'm assuming that they are working on that. We're having conversations with them as to how would we support them if that was to take place and when it'll take place, will we have the capacity in place to be able to support that shift? And that's really our focus, is being ready for that event when and if it takes place.

David Windley
Analyst, Jefferies LLC

Q

Got it. Let's shift to margin. The – probably, benefiting from both the COVID push in 2020 and 2021, but also the underlying non-COVID Biologics lift that you've already highlighted. Margin expanded 600 basis points in 2021, then in the first quarter backed up a bit year-over-year. Could you just talk about some of the moving parts that are influencing margin and the margin progression?

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

A

Yeah. So, the – in Q1, there were two callouts really that impacted the margin expansion. And one was, there was a take or pay revenues that we had in Q1 2021 and that was about circa $15 million. So, the comp against that was always going to be pretty difficult and that had about 160 basis point impact on our operating margin.

And then, also, we had some issues in the early part of the quarter with COVID-related impacts on some of our US sites, particularly our high-value product sites. That resolved itself as we moved through the quarter, but it did impact our ability to produce in the early part of the quarter. And so, again, that had a one-time impact on margins.

So, if you adjusted for the 160 basis points impact of the take or pay, our margin would have actually expanded Q1 2022 over Q1 2021. So, we would – on our long-term horizon, we're still talking about 100 basis points expansion year-over-year on operating margin. And as we progress through 2022, we would expect to see margins step up quarter-over-quarter.

David Windley
Analyst, Jefferies LLC

Q

Okay. You also talked a little bit about, given the environment we're in, inflation, supply chain disruptions, et cetera, that you're adding some surcharges into your pricing structure. And then, the yield, which I think historically has tended to be about 1% to 2% on price yield, was more like 3.5% in the first quarter. Can you talk about kind of pricing strategy, how much are you pushing through that you would view as more temporary? How much is more of a permanent price taking, and is that higher price taking something that you expect to do long term?

Bernard J. Birkett
Senior Vice President & Chief Financial Officer, West Pharmaceutical Services, Inc.
A

Yeah. So, we – as we went through the back end of 2021 and we were setting our prices for 2022, we did incorporate some inflationary cost increases that we forecast coming through and that was part of that 3.5%. Now, we didn't break out exactly how much. But in addition to that, we had been reviewing our pricing strategy and the methodology we were using as to how to capture value and capture more price. And we had done work through 2021 on that.

So, even without the inflationary addition to pricing, we would have been increasing our pricing [indiscernible] (00:16:49) for 2022, and that's something that we will continue to look at as we move beyond 2022. So, it's really understanding how best we should capture value within West. I think in the past, we looked at 1% to 2% just being sufficient, but there has been kind of a shift in our view in that.

On the other inflationary costs regarding freight, certain increases on components and raw materials, they are passed on to customers through surcharges that they're not included in that pricing adjustment. But that's again – that's been ongoing. We've been doing some of that since 2020 as we've seen freight costs increase as we went through the COVID experience and on into 2021.

On the other side, on managing those inflationary costs, we have hedges in place around oil. So, we hedge about 60% of our exposure around oil-related products, and we have an 18-month rolling hedging policy in place. So, we're actually seeing that as a benefit as we're going through 2021. And then, from lot of our utilities, there's fixed price contracts in place through this year. And again, that's something that we'll have to review as we move into 2023 and then how does that inform our pricing strategy as we move into next year.

David Windley
Analyst, Jefferies LLC
Q

Just a quick clarification on the utility point. Are those also rolling or are you saying all your utility contracts are coming up this year?

Bernard J. Birkett
Senior Vice President & Chief Financial Officer, West Pharmaceutical Services, Inc.
A

There will be – some will roll into 2023, and then some will have to be renegotiated for 2023.

David Windley
Analyst, Jefferies LLC
Q

Okay. In terms of the – I guess, one of the historical postures around pricing has been kind of not to poke the bear, so to speak, like don't take so much price that you dare the client to look elsewhere. Maybe talk about how that philosophy has changed?

Bernard J. Birkett
Senior Vice President & Chief Financial Officer, West Pharmaceutical Services, Inc.
A

Well, it's still – the philosophy is similar, but it's just we believe that in certain areas of our business, we're able to expand on that pricing strategy. So, there is more value we can capture based on what we're bringing to the market. So, it's not as if we're suddenly going to go across the market and increase prices exorbitantly. It's a measured approach because the relationship we have with our customers, these are long-term partnerships and that's what we want to maintain.

David Windley
Analyst, Jefferies LLC
Q

Got it. Okay. So, then moving on to a more – maybe more longer term strategic development is, I think, the company's view that the end market will evolve toward more of an integrated delivery model, where you're not just providing a component but you're providing more of a system that – where the need will be driven by very hard to deliver drugs and self-administration at home and things of that sort in the trend. So, maybe talk about how you're building toward that. And, Quintin, looks like you're going to answer this one, how does Valor Glass fit into that?

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

Dave, this has been a trend that has been coming for a while now. Our customers and the regulators that regulate them are looking not only at the quality and the reliability of the components, but they're looking at it as how the components all are put together as a system. Today, for injectable drugs, it's piecemeal. They'll buy an elastomer; they'll buy a glass; they'll work with a different fill-finish company; and each one has their own different processes. And especially on the glass and elastomer side, you could be looking at multiple drug master files that you're having to juggle for not just the component, but the processing that goes along with it.

The opportunity that we have now to work with an now to work with an established player like Corning who brings a wealth of knowledge and experience on glass to develop a truly integrated system where – from manufacturing, how the elastomer and the glass work together, fully characterized, single drug master file, we believe will be a truly innovative system that does not exist today.

Well, since we've announced that deal, the customer feedback has been very positive. They have reinforced that this is what they've been looking for. This is what the regulators are looking for. And so, over the next few years, we're going to be investing in capital and product development. And you can expect to see new offerings being launched that will go to where we'll be providing both from a PFS, a pre-filled syringe, and vial and cartridge formats.

David Windley
Analyst, Jefferies LLC
Q

Okay. Last question, Bernard, for you on capital allocation. I looked back through my model and, over five years, your net [indiscernible] (00:22:57), you've gone from small net debt to about just shy of $4 net cash or just shy of $5, I think, of net cash. Your positive cash flow and you can fund your CapEx out of annual cash flow. What are your thoughts about how the company wants to use what is now growing store of latent cash?

Bernard J. Birkett
Senior Vice President & Chief Financial Officer, West Pharmaceutical Services, Inc.
A

Yeah. So, in the past, we have focused on really CapEx deployment for organic growth, and we have a modest share buyback which is just to cover share creep, and then we have our regular dividend payments.

So, what we are focusing on more in the future is looking at M&A and looking at areas where we can, from a strategic point of view, where we should be adding more capability to support our customers, which will be close to our core. Our plan is not to go too far away from the things that we do today, but there will be more focus in that area.

But it's also bearing in mind that we have like kind of strict guidelines around where we will invest and what level of exposure we will take on, and we're also very cognizant that we have a very powerful organic growth story, and it's also making sure that we don't get distracted from that, but M&A is becoming more of a priority for us at this point.

David Windley

Analyst, Jefferies LLC

Excellent. I think that brings – or we'll land the plane there. That brings us to the end of our session. Thank you to the West guys for your attendance and participation and to our audience for listening in, and enjoy the rest of the conference. Thank you.