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West Pharmaceutical Services, Inc. (WST)

Q2 2022 Earnings Call

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OTHER PARTICIPANTS

Derik de Bruin

Analyst, BofA Securities, Inc.

Justin Lin

Analyst, William Blair

Paul Richard Knight

Analyst, KeyBanc Capital Markets, Inc.

Jacob Johnson

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Larry S. Solow

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MANAGEMENT DISCUSSION SECTION

Operator: Good day and thank you for standing by. Welcome to the Q2 2022 West Pharmaceutical Services Conference call. At this time, all participants are on a listen-only mode. After the speakers presentation, there will be a question-and-answer session [Operator Instructions] Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker for today, Quintin Lai, Vice President, Investor Relations. You may begin.

Quintin John Lai

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

Thank you, Towanda. Good morning and welcome to West's second quarter 2022 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 westpharma.com. This morning, Eric Green and Bernard Birkett, will review our financial results, provide an update on our business, and present an update on our financial outlook for the full year of 2022. There's a slide presentation that accompanies today's call, and a copy of that presentation is available on the Investors section of our website.

On slide 4 is our Safe Harbor statement. Statements made by management on this call and in the accompanying presentation contain forward-looking statements within the meaning of US federal securities law. These statements are based on our beliefs and assumptions, current expectations, estimates and forecasts. The company's future results are influenced by many factors beyond the control of the company. Actual results could

differ materially from past results, as well as those expressed or implied in any forward-looking statement made here.

Please refer to today's press release, as well as any other disclosures made by the company regarding the risk to which it is subject, including our 10-K, 10-Q and 8-K reports. During today's call, management will make reference to non-GAAP financial measures, including 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 our CEO, Eric Green.

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Thank you, Quentin, and good morning, everyone. Thanks for joining us today. We will start on slide 5. I'm pleased to report that we delivered an excellent second quarter. We grew 13% organically with over 18% organic sales growth in our Proprietary Products segment. Our base business continues to have solid demand across all three market units: Biologics, Pharma, and Generics, which more than offsets a slight decline in COVID-19-related sales. And again, our high-value products led the way to this impressive growth.

Our continued success highlights the strength and resilience of our proven strategy of Execute, Innovate, Grow which continues to set us apart as a trusted market leader. It is the strength of our One West team, guided by our purpose that makes a meaningful difference in ensuring our customers have reliable supply of the components necessary to deliver drugs to patients. An example of our One West culture in action is our team members in China who I would like to thank for their inspiring efforts and commitment to our customers during the lockdowns in April and May. The relentless focus in our purpose enabled us to reopen our sites and continue to serve our customers with minimal impact.

Now moving to slide 6. We made great progress in the second quarter. Let me briefly share a few highlights. We continue to deliver the key drivers of growth in Q2, primarily driven by our HVP components, including NovaPure, Envision, Daikyo Crystal Zenith and self-injection devices.

With a strong order book for our Biologics and Generics customers, along with Pharma demand ramping up, we are seeing the benefits of our capital spend investments as we optimize productivity across our global operations. Our 2020 capital expansion is now complete and we're driving forward to complete the installation of our 2021 expansion.

Turning to Crystal Zenith. We have made an expanding capacity of our 1 ML syringe as our customer uptake has been robust at the 2022 BIO International conference, we launched the Daikyo Crystal Zenith 2.25 ML Insert Needle Syringe system. With a market trend for larger dose injections, we're able to answer the needs of more patients with a safe and reliable containment solution. The new CZ syringe system will help our customers bring a larger volume of product to patients with fewer or less frequent injections, enabling an easier patient experience.

As we continue to advance the standard of care for patients with our customers, I'm pleased to share that we have a combination drug approved using our newly launched CZ 2.25 ML system with targeted customer launch in 2023. In addition, we're seeing good progress with our SmartDose On-Body subcu delivery system and now have three FDA approved biologic drugs using our technology.

Shifting to slide 7, and an update on ESG. At the end of June, we published our 2021 Corporate Responsibility Report on the company website. We are tracking well towards our five-year targets and I'm proud of how our organization has connected our One West culture with our ESG initiatives. We know to fulfill our purpose effectively, we must progress our environmental sustainability goals, diversity and inclusion and success around our charitable efforts. Together, this makes for a better-performing company today and into the future.

I'm also pleased to share that yesterday we announced that our Board of Directors has elected Dr. Stephen Lockhart as our newest member. As the former Chief Medical Officer of Sutter Health in California, his expertise will be a valuable addition to our board. Before I turn it over to Bernard, I want to provide some high level thoughts on our updated full year outlook and implied second half 2022 guidance. We have two headwinds: FX and slowing COVID-19 demand. On the positive, not only has our base business been strong in the first half of the year, but we also expect the Generics and Pharma market units to perform even better in the second half of the year with additional resources to address the demand dynamics.

For guidance, we're taking the overall sales down by \$100 million for the full year. Incremental FX is going to be a \$75 million headwind. In addition, we're seeing a decline in COVID-19 demand as compared to our April outlook that assumed modest growth over 2021. While we're seeing some orders for stoppers for smaller vials to hold fewer doses, we do not assume a meaningful sales impact in 2022 and expects an sales impact in 2022 and expect an overall decline of COVID-19 sales of 20% or \$85 million from 2021 sales levels.

To sum it up, changes in FX and COVID are causing headwinds well in excess of our \$100 million negative change to full year sales guidance. On the positive side, we're expecting even stronger base business growth in the second half of this year from all three market units of Biologics, Pharma and Generics that is helping to moderate the guidance impact.

Now I'll turn over the call to Bernard.

Bernard J. Birkett

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

Thank you, Eric, and good morning. Let's review the numbers in more detail. We'll first look at Q2 2022 revenues and profits where we saw another strong quarter of sales growth led by performance in our Biologics and Generics market units. I will take you through the profit drivers in the quarter as well as some balance sheet takeaways. And finally, we will provide an update to our 2022 guidance.

First up Q2, our financial results are summarized on slide 8 and the reconciliation of non-US GAAP measures are described in slide 17 to 20. We recorded net sales of \$771.3 million representing organic sales growth of 13.1%.

Looking at slide 9, Proprietary Product sales grew organically by 18.3% in the quarter. High-value products, which made up approximately 73% of Proprietary Product sales in the quarter, grew double-digits and had solid momentum across Biologics and Generics market units in Q2. Looking at the performance of the market units, the Biologics market unit delivered strong double-digit growth. We continue to work with many biotech, biopharma customers who are using West and Daikyo high-value product offerings. The Generics market units also experienced strong double-digit growth led by sales of FluroTec and Westar components.

Our Pharma market units saw mid-single-digit growth with sales led by high-value products, including NovaPure components. And Contract Manufacturing declined 8.9% for the second quarter due to a reduction in sales of components for diagnostic devices. We recorded \$321.5 million in gross profit, \$6.4 million or 2% above Q2 of last year. And our gross profit margin of 41.7% was a 180-basis-point decline from the same period last year.

We saw improvement in adjusted operating profit with \$227 million recorded this quarter compared to \$211.2 million in the same period last year for a 7.5% increase. And our adjusted operating profit margin of 29.4% was a 20-basis-point increase from the same period last year. Finally, adjusted diluted EPS grew \$0.01 for Q2 excluding stock-based compensation, tax benefit of \$0.01 in Q2, EPS grew by approximately 4%.

So let's review the drivers in both revenue and profit. On slide 10, we show the contributions to sales growth in the quarter. Volume and mix contributed \$71.7 million or 9.9 percentage points of growth and sales price increases contributed \$23.4 million or 3.2 percentage points of growth in the quarter.

Looking at margin performance, slide 11 shows our consolidated gross profit margin of 41.7% for Q2 2022 down from 43.5% in Q2 2021. Proprietary Products second quarter gross profit margin of 46.2% was 360 basis points lower than the margin achieved in the second quarter of 2021. The decline in Proprietary Products gross profit margin was caused by inflationary pressures impacting all plant costs including raw materials, labor and overheads.

Partially offsetting these inflationary headwinds was improvement in our product mix, price increases and pass through surcharges and approximately 90 basis points of benefit associated with one-time fees from COVID supply agreements. Contract Manufacturing second quarter gross profit margin of 16.3% was 40 basis points below the margin achieved in the second quarter of 2021. The decrease in margin is largely attributed to mix of products sold in the period.

Now let's look at our balance sheet and review how we've done in terms of generating more cash. On slide 12, we have listed some key cash flow metrics. Operating cash flow was \$324.3 million for the six months ended June 2022, an increase of \$91.2 million compared to the same period last year, a 39.1% increase. Our operating cash flow in the period benefited from increased earnings, our working capital performance and timing of income tax payments.

Our second quarter 2022 year-to-date capital spending was \$131.9 million, \$20.3 million higher than the same period last year. Working capital of approximately \$1.2 billion at June 30, 2022 increased by \$58.1 million from December 31, 2021, primarily due to increases in accounts receivable and inventory offset by reductions in our cash. Our cash balance at June 30th at \$718.5 million was \$44.1 million lower than our December 2021 balance. The decrease in cash is primarily due to our share repurchase program and higher CapEx, offset by our strong operating cash flow in the period.

Turning to guidance, slide 13 provides a high level summary. We are updating our full year 2022 net sales guidance and expect net sales to be in the range of \$2.95 billion to \$2.975 billion compared to our prior guidance range of \$3.05 billion to \$3.075 billion.

There is an estimated headwind of \$190 million based on current foreign exchange rates compared to a prior estimated headwind of \$115 million. We expect organic sales growth to be approximately 11% compared to prior guidance of approximately 11% to 12%. We expect our full year 2022 adjusted diluted EPS guidance to be in the range of \$9 to \$9.15 compared to a prior range of \$9.30 to \$9.45. This revised guidance includes our first half \$0.13 EPS positive impact of tax benefits from stock-based compensation.

Also, our CapEx guidance remains at \$380 million for the year. There are some key elements I want to bring your attention to as you review our guidance. Estimated FX headwind on EPS has an increased impact of approximately \$0.55 based on current foreign currency exchange rates compared to a prior estimated headwind

of \$0.38. We expect full year COVID-19 related sales to be approximately \$85 million lower than 2021 sales. And our guidance excludes future tax benefits from stock-based compensation.

To summarize the key takeaways for the quarter, strong top-line growth in Proprietary, growth in operating profit, solid adjusted diluted EPS despite FX and inflationary headwinds and growth in operating cash flow delivering in line with our pillars of Execute, Innovate and Grow.

I would now like to turn the call back over to Eric.

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Thank you, Bernard. To summarize on slide 14, our performance in Q2 as physicians well for the second half of the year. We continue to have a strong base business, which is a testament to the foundation we have built over time with the right strategy and execution. Leveraging the benefits of our global operating model to deliver a robust book of committed orders and continue to accelerate capital spending across our operations to meet current and anticipated future growth.

So Towanda, we're ready to take questions. Thank you.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Derik de Bruin with Bank of America. Your line is open.

Derik de Bruin

Analyst, BofA Securities, Inc.

Hi. Good morning, everyone. Thanks for taking the question.

Q

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Good morning, Derik.

A

Derik de Bruin

Analyst, BofA Securities, Inc.

Hi. So could you be a little bit more specific on the COVID headwind? I mean, you called out \$85 million versus prior, but your prior guidance included some growth with it. I'm basically – I'm just trying to say – I'm just trying to make sure I – trying to back into a more specific number for the over – for the organic revenue growth boost to the core business. It looks like – I'm back into roughly a 3% increase from your prior guide to sort of your – if I just – just I'd like to work the math out a little bit better to give me some little bit more guide.

Q

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Yeah, Derik. Let me give you a little more color on that. If we think about 2021, our revenues for COVID were – was approximately \$460 million. What we're seeing in 2022 based on the current visibility and discussions with customers, we're looking at about a 20% reduction of that number, which is about \$85 million. And if we kind of

A

look at – and it's – again, this is based on the variability that we're seeing in the industry right now. If you think about moving forward for 2023, we do believe...

Derik de Bruin

Analyst, BofA Securities, Inc.

Yes.

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

...there's probably another 30% or maybe up to 50% reduction of the 2022 number.

So that's kind of the glide path we see with COVID-19 demand right now. This is – you are correct, there's implied base business increase and that's what we're seeing with particularly around biologics and a stronger Pharma and Generics in the second half. So the ex-COVID business, if we look at the Proprietary, it was roughly around 23% growth in Proprietary for the second quarter and that's robust that we're seeing that continue for the balance of the year.

Derik de Bruin

Analyst, BofA Securities, Inc.

Great. Well, thanks for preempting my 2023 COVID question, which is going to be the follow-up to that, so thanks for that. And so I guess the question, but then [indiscernible] (00:19:32) it's like have you de-risked the number enough for 2022, right? Is there further downside to that \$85 million?

Bernard J. Birkett

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

Well, based on the information that we have right now, what we believe we have de-risked it enough. And based on the facts that we see again, COVID is – there's always this changing landscape with it depending on what's going to happen this year and probably into 2023. But we have taken a conservative view I would think around COVID.

Derik de Bruin

Analyst, BofA Securities, Inc.

Got it. And it looks like you call that a 90-basis-point margin boost [ph] to PPE (00:20:12). Was that related to a cancellation fee that might have come in the quarter from COVID projects?

Bernard J. Birkett

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

That's correct.

Derik de Bruin

Analyst, BofA Securities, Inc.

Okay. And any issues in terms of – I mean, this comes up – this is coming up frequently in terms of my incoming questions, in terms of customer inventory stocking, just sort of any signs of [ph] anything addressing the (00:20:37) supply chain.

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Right now, Derik, if we think about – yeah. No, Derik, when we look at the order book today, one area that we're focused on is – are our lead times. As you can imagine, the last couple of years with the COVID demand, we had to pivot and prioritize in certain parts of our product portfolio. So our focus right now is reduce lead times back to where they should be. And that's why you hear us talk about we have capacity that is being installed as we speak, but also into 2023, which will give us more capability to support our customers on the increase in demand we're seeing, in particular on Biologics and in particular on the higher end of high-value products. So that's the focus we have. We don't see – based on the demand and discussion of the customers, it's not a large restocking concept going on right now with the underlying core business.

Derik de Bruin

Analyst, BofA Securities, Inc.

Great. And just question from a client, can you [ph] just qualify (00:21:45) the cancellation fee? How big a number would that was?

Bernard J. Birkett

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

Approximately \$12 million.

Derik de Bruin

Analyst, BofA Securities, Inc.

Great. Thank you very much.

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Thank you, Derik.

Operator: Thank you. Please standby for our next question. Our next question comes from the line of Paul Knight with KeyBanc. Your line is open.

Paul Richard Knight

Analyst, KeyBanc Capital Markets, Inc.

Hi. Hi, Eric. Thanks for the time. Regarding the 23% Proprietary growth, obviously, we are seeing biologic approvals strong. But one area that seems to be – get numbers around is biosimilars. How big is biosimilar benefit in the market and to West? Can you have a quantitative or qualitative read on the biosimilar tailwinds?

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Yeah. No, thank you, Paul, for the question.

Though, we're seeing the benefits of the biosimilar approvals and entry into the marketplaces all over, although I would say it's relatively small in a scheme of the entire Biologics portfolio and there's a high value product adoption. So when you think about the packaging configurations with our biologic customers, it's near identical to what we see with the biosimilars.

Paul Richard Knight*Analyst, KeyBanc Capital Markets, Inc.*

Q

And is the trend to single dose syringe pretty dramatic or changing in your view?

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

That's one area where we're investing heavily and specifically give you – really specific areas around NovaPure plungers. And that is – it supports, what you're saying is that there's a tremendous movement towards prefilled syringes and in the Biologics space, in the biosimilar space you're looking for, it's a high adoption of NovaPure. So that's where our investments are going. We have installations going on in 2022, but also in 2023 to start getting ahead of the curve with our customers.

Paul Richard Knight*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. And then last, Bernard, the FX guide that was \$115 million for this year and now it's minus \$190 million for the full year. Is that the way we – what you said earlier?

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

A

That's correct.

Paul Richard Knight*Analyst, KeyBanc Capital Markets, Inc.*

Q

Okay. Thank you.

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

Thank you, Paul.

Operator: Thank you. Please stand by for our next question. Our next question comes from the line of Larry Solow with CJS Securities. Your line is open.

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

Q

Hi. Good morning. Thanks for taking my questions. Just bouncing through a couple of other calls that. Can you just review – so for the guidance. So the currency impact is \$75 million and then the net sales impact, I guess is \$25 million. Did I get that right? It's \$85 million less COVID and then you're adding back essentially \$60 million plus from the base business. Is that – am I capturing that?

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

That's correct, Larry, you have that accurate.

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

Q

Okay, great. And then on – and then you just mentioned you kind of called out in terms of COVID-related sales, vaccine-related sales dropping this year, like you said, 20%. And then you think there may be another 50% drop in volume demand in 2023, I think I caught that right. And then, and then the offset to that obviously, hopefully some offset there would be moved to a more – I know you to the prefilled syringes or less doses per vial. It sounds like a little bit is happening in that in 2022. Can you just give us sort of an update on how you see that transforming in 2023 and as we go on? Are you still confident that we'll, we'll see a pretty good transformation on the COVID side onto single dose?

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

Yeah, Larry, you summarized that well. I just want to add one comment, though, the 2023...

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

Q

Sure.

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

...we do see more of a range of 30% to 50%. Again, there's a lot of variability. So we're trying to be conservative on that.

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

Q

Absolutely.

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

Your point is valid that there is a shift that is starting to occur with less doses per vial.

So that configuration is obviously, in some cases, some customers has moved from a 20 millimeter down to a 13 millimeter stopper. What we're seeing right now is more in the vial configuration versus prefilled syringe. We'll see that more into 2023 and beyond. I do want to just state you're right, there's less doses per vial, which is a net benefit to West, but the key variable that is very unpredictable right now is the number of patients taking the dose. And the data is widely available in the market and you've see the low uptake as we speak right now, but yet to be determined as we get through 2022 and also into 2023.

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

Q

Yeah, right – yeah, please.

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

A

To add to that, the prefilled syringe uptake that Eric just mentioned when answering the other questions is really within our core business within Biologics, that's where we're seeing a lot of increased demand move in – move through 2022 and into 2023. So [ph] layering in half way so that's for (00:27:31) core business.

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

Q

Right. Right. So that, right – so that big sort of – let's switch on a macro level. Prefilled syringes are certainly increasing across the biologic space and not just specifically the COVID vaccine. We're hopeful that will happen. And there's certainly some talk of that I'm sure with all your customers. But you're talking in general that trend, that multiyear trend, which you're talking about for a while. And then on NovaPure itself, can you just give us like an idea – it seems like – well, I know you don't break out percentages of penetration, but it seems like we're still relatively in the early stages. Can we just – can you just like maybe qualitatively compare like the penetration of NovaPure to say FluroTec or Westar one of your more highly penetrated [ph] non-HVPs (00:28:17)?

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

Yeah. I would say what's commercial in the market right now. The NovaPure is a lower percentage than the other parts of the high-value product portfolio. When you look at the pipeline and/or newly approved drugs that are ramping up in the marketplace, there's a higher percentage that's utilizing the NovaPure particularly around the plungers. And that lines up very nicely to the investments we're making this year and next year that we've committed to already to have installation and capacity expanded quite significantly. So that's where we are in that journey. While it's a lower percentage, it has tremendous value proposition to our customers. And that's why we see the pipeline as very attractive, particularly in the biologic space.

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

Q

Great. And just lastly and [ph] I get you (00:29:11) spoke a lot about and it sounds like you're really enthusiastic about sort of the outlook for the self-injectables and you mentioned – can you just give us sort of an update? I know you've talked a lot about the CZ and the new 2.25-milliliter insert. Can you just give us sort of an update on SmartDose? Where we stand with that and how you see that unfolding over the next few years? Thanks.

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

Larry, this is an area that we've been working on for a number of years. And what we talked about more recently is our customers are looking at ways of taking new molecules, but also current molecules in the market, reformulate and move it from an IV to a subcu delivery mechanism, and particularly around lifecycle management. And that is actually quite exciting. And hence, when you think about – I mentioned on the call in the prepared remarks that we now have three combination device approvals with Biologics. And so we're starting to gain momentum, start moving products into the commercial environment versus still in development.

When I look at the development projects we're working on with a number of customers, it is now more gravitating towards the larger volumes, existing molecules in the marketplace, and it's around lifecycle management. So it's exciting, I believe we are in a good point in time. The more work investments need to occur, it's going to take some time to get into really large, meaningful revenues. But we're definitely on – in the right direction with that part of the portfolio.

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

Q

Great. Excellent. Appreciate all the color. Thanks.

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

Thank you, Larry.

A

Operator: Thank you. Please stand by for our next question. Our next question comes from the line of Justin Lin with William Blair. Your line is open.

Justin Lin*Analyst, William Blair*

Hi. Good morning. Congrats on the quarter. I'll start off with a simple one here. Do you have any plans for any further price increases for the rest of the year. Just trying to get a sense of what's assumed in your guidance?

Q

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

Well, right now it's continuing with the pricing strategy that we've had as we've progressed through 2022 where we've done some specific price increases for customers, general price increases and then we continue to monitor if there are further surcharges that we need to implement as these inflationary costs continue to hit us as we move through the second half of the year and it's something we review on a monthly basis. I'm not going to announce to say there's any specific increase at the moment. Again but we are tracking it pretty closely and offsetting as much of that cost increase as we can. And as we've talked about before, there's sometimes a lag as to when we experience the cost increase itself and then when we can pass it on and again that's something we're working through, but again its fluid.

A

Justin Lin*Analyst, William Blair*

Got it. And can you remind us how we should think about margin cadence for the rest of the year? And I guess, what are the underlying assumptions around raw material cost rate and overall supply chain?

Q

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

Yeah. So, we see that margin continue to step up as we move through the remainder of the year. Again, that's based on what we have been communicating and since we gave guidance in February of this year. And we will continue to see that happening as we improve our levels of efficiency and layering extra capacity. Some of the things that we're having to do right now is to replace the COVID demand that we've just called out as decreasing with other products and other demand within our network and we've been – start doing that in – as we progress through Q2, that'll continue to Q3 and Q4. And the demand is there, essentially, to fill many of our facilities, and that growth is reflected in the guidance. It's embedded.

A

Justin Lin*Analyst, William Blair*

Got it. That's very helpful. And just one last one for me. So, longer term, that 100 bps of margin improvement each year, I guess is that predicated on inflation and supply chain pressure easing in 2023, or can you achieve that without the situation improving? In other words, will the continued uptick in high-value products alone help drive that, obviously along with sort of the continued increase in efficiency?

Q

Bernard J. Birkett

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

Our expectation is that that would be the case. Our target is to continue to expand margins by 100 basis points, and that's based on what we can see today. Now, if some black swan event or something happens that's outside of our control. That's a different story. But based on what we have in front of us today, the intention is to continue that 100-basis-point expansion.

Justin Lin

Analyst, William Blair

Sounds good. Thank you.

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Thank you, Justin.

Operator: Thank you. Please stand by for our next question. Our next question comes from the line of Jacob Johnson with Stephens. Your line is open.

Jacob Johnson

Analyst, Stephens, Inc.

Hey. Good morning. Just one quick housekeeping question first. On the COVID revenue in 2Q, you talked about 23% growth ex-COVID in Proprietary Products. That seemed to imply that COVID revenues were maybe \$110 million in the quarter. Is that in the ballpark?

Bernard J. Birkett

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

Yeah, it's pretty close.

Jacob Johnson

Analyst, Stephens, Inc.

Okay. Thank you. And then, Eric, you mentioned the potential for Pharma and Generic demand to pick up in the second half of the year and you also mentioned adding some resources there. Can you just talk about that the resources you're adding there and were you somewhat capacity constraints for those end markets in the first of this year?

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Yeah. So we're – as resource is more around the demand built to deliver on the demand that has been given to us specifically in Generics and Pharma. And there are discrete customer projects. So, we're feeling good about the work that's ahead of us. But we did – we do need to allocate resources properly to really deliver those demands that – for a second half of this year.

That was the intent back on it, particularly with Pharma and Generics. So if you take the first half of the year compared to the second half, those two units will be growing a lot faster than they were in the first half. So that

that's – I just want to make sure that was clear that was – that's going to be occurring from our plants both in Europe and also in the United States.

Jacob Johnson

Analyst, Stephens, Inc.

Q

Okay. That's helpful. And then, last question, for Bern, just on R&D expense, they're kind of flattish sequentially. I think if I remember correctly there are going to be some investments flowing through the R&D line, maybe around the Corning relationship and some other efforts. Just how should we think about R&D expense maybe back half of this year into 2023?

Bernard J. Birkett

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

A

Yeah, we would expect it to take off in the second half of the year and that there are going to be two drivers around that. One is the level of DAs that we're seeing coming through our pipeline and then that's really on our delivery devices. And then also looking at the Corning glass partnership that we have in place, we'll be adding additional cost. And again, it's all embedded in the guidance. It must have been planned for the year, but that'll happen in the second half of the year, but more so in Q4 than in Q3.

Jacob Johnson

Analyst, Stephens, Inc.

Q

Okay. Perfect. Thanks for taking the question.

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

A

Thank you, Jacob.

Operator: Thank you. Please stand by for our next question. Our next question comes from the line of Dave Windley with Jefferies. Your line is open.

David Windley

Analyst, Jefferies LLC

Q

Hi. Thanks for taking my question. Good morning, gentlemen. I was hoping to try to shine a little bit more light on the comments around bias toward prefilled syringe, NovaPure stoppers that you – or excuse me, NovaPure plungers that you mentioned CZ uptick and work around syringes there. Like how much of that is related like – so as clients want prefilled syringe is that still predominantly glass and you're supplying what you traditionally have, but in NovaPure high-value or is that also driving uptick in CZ resin syringes? Just anything you can add there would be much appreciated.

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

A

Yeah. So, no, Dave, good morning. It's – CZ is a great application when you started thinking about silicone free. But from – but the preference is, is still glass, hence the investment and the work we're doing with – partner with Corning. So there are certain molecules, certain applications that CZ is particularly well positioned for and we're able to capture some of that demand. Now when it comes to NovaPure plungers, really the comment is around the glass PFS solution and also more around the Biologics and biosimilars than anything else.

David Windley*Analyst, Jefferies LLC*

Q

Okay. And then Eric in your comments around addressing shortening lead times, I want to make sure, I mean, sounds like the base business is accelerating to I think it was Larry's bridge or maybe Paul's bridge around the \$60 million of the base that makes up for some of the weakness. How much of that is I'll say pulling forward activity because space and productive capacity is freed up by the lowering of COVID and to help to shorten lead times for your clients versus kind of underlying steady state flow of demand. Can you help us to understand the difference there?

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

Yeah, the long-term construct we still believe in the [ph] 70% to 90% (00:40:20). So when we started talking about 23% in the quarter for Proprietary excluding COVID that is obviously outsize that long-term construct, and there's two elements to that. One is we do believe the freeing up some of the capacity, which is obviously not just dedicated to COVID it will be able to support our core business and to bring some of those lead times in line. It's not the entire portfolio, but specific area, probably more around the high-value products. When you think about the market units, Biologics is still really strong. What I mean by that is we think about our order – confirmed order book, it continues to increase from the end of last year.

And one of the major drivers of that is Biologics and we dig a little bit further. It's the combination of recently launched molecules that are having a very strong success in the marketplace. And secondly, it's new – preparing for the pipeline for new – newly approved drugs that are – will be approved or have been approved recently. There is always inventory management going on with our customers. But I would say in the last two or three years, we were not in a position to be able to oversupply any one particular customer. So we're trying to bring the lead times back in line. That's constant work that we're focused on. But I want to state that the underlying growth of this is extremely healthy across all markets and especially biologics.

David Windley*Analyst, Jefferies LLC*

Q

Got it. Thanks. So I guess to rephrase that last point that you just made. So you're confident that customers are not safe stocking because you basically couldn't produce enough for them to overstock. Maybe to flip the question, were they under-stocked or I guess a version of that would be kind of dependent on longer lead times than are comfortable, and so you're kind of catching up and getting them shored back up to what normal should be? It sounds like to what you're saying.

Eric Mark Green*President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.*

A

Dave, you're right – yeah, Dave, you are correct. There are some cases not across the whole portfolio, but there's some cases where we – with the relationships we've had with our customers is to establish very robust schedules or tight schedules to make sure that we're not creating any issues of availability of material. But there was some of that and we're working through those as we speak. And that's one of the reasons why we highlighted that some of the capital investments that we made are committed to that are rolling in, in this year and also into next year, particularly on NovaPure is to really alleviate to support the growth in the Biologics space. And that's definitely needed to get in there to stay ahead of the curve.

David Windley

Analyst, Jefferies LLC

Got it.

Q

Bernard J. Birkett

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

The way I would frame it is to bring lead times back to where they are, pre-COVID, and that's to be able to maintain those lead times as the business is actually growing rather than having the lead times go back out. So that's where you have to layer in the capacity. So it's actually managing two things at once. It's not just one. So we're seeing this acceleration in growth in some areas of our business and plus trying to get customers' stock levels, where they feel comfortable if that's the case. But that's going to take a period of time. That's not an instantaneous thing.

A

David Windley

Analyst, Jefferies LLC

Sure. And, Bernard, on your point on layering in the capacity, just to confirm, this change in your – or does this change in your COVID expectations, change the amount of CapEx investment or the pacing of those projects at all relative to bringing on additional capacity?

Q

Bernard J. Birkett

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

The projects that we have right now, it does not change any of those. And the projects that Eric mentioned about, particularly on the plunger side, we're continuing to layer in that capacity. And that's specifically around growth that we're – that's inherent in the market right now and the changes that were seen. And so there is no change there. And if we could actually accelerate that onboarding that would be more beneficial for us if we could do that, because the demand is there today.

A

David Windley

Analyst, Jefferies LLC

Got it. It seems like a strong sign. Last question for me, in regard to stoppers versus plungers and components that you supply for prefilled syringe, I think you've answered in the past that you're relatively, economically agnostic to form factor. Is that true or is there any nuance that we should think about there?

Q

Bernard J. Birkett

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

No, that's – that holds true. The economics aren't that vastly different between the two.

A

David Windley

Analyst, Jefferies LLC

Okay. Thanks. I appreciate you're answering all my questions.

Q

Eric Mark Green

President, Chief Executive Officer & Chair of the Board, West Pharmaceutical Services, Inc.

Thank you, David.

A

Bernard J. Birkett

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

A

Thank you.

Operator: Thank you. I'm showing no further questions in the queue. I would now like to turn the call back over to Quintin Lai for closing remarks.

Quintin John Lai

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

Thanks, Towanda, and thank you for joining us on today's conference call. An online archive of the broadcast will be available on our website at westpharma.com in the Investor Section. That concludes this call. Have a nice day.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

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