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West Pharmaceutical Services, Inc. (WST)

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MANAGEMENT DISCUSSION SECTION

Daniel Brennan
Analyst, UBS

Well, I guess we're live. Well, thanks everyone for coming. My name is Dan Brennan, and I'm the new Life Science Tools and Diagnostics Analyst from UBS, and welcome to day one of UBS Healthcare Conference. I'm pleased to be joined on stage with the senior management team of West Pharma. To my left is Eric Green, the President and CEO, and to his left is Bill Federici, SVP and CFO.

So I have a series of questions obviously prepared, but I think most of you have the little flyer showing you how to kind of log on and [indiscernible] (00:00:30) questions here. So I'll certainly glance down during the presentation and try to get to those. But to start off, we're going to have Eric and Bill make some opening comments.

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

Great, excellent. Well, Dan, first of all, I want to thank you and UBS for inviting us to the conference this year. It's been a very good day so far, and we look forward to the rest of the afternoon. We have a fantastic story to talk about at West. West is aged 95. This year we're celebrating the 95th year the company has been in existence. And we have been critical in the injectable medicine space since 1923 when the founder Herman O. West envisioned to be a very important part about primary containment of molecules in the marketplace.

When you start thinking about West and the diversity of the organization, we're on the top 50 biologic injectable drugs in the marketplace today. You look at the top 75 pharmaceutical biotech firms, we are actually participating in their pipeline but also molecules that have been commercialized.

And we start thinking about the scale at West. We produce roughly around 41 billion components a year, which I'm actually quite proud. The main focus, when you walk into a facility and talked to our colleagues who are producing these products each and every day of the 28 facilities, they realize that each and every component of the 41 billion has a name on it. So there is a really high level of quality that comes out of our operations and to our customers' hands.

From a geographic point of view, most of our revenues are outside the United States. We're roughly around 50% U.S. and 40% in Europe and then the balance in Asia Pacific and Latin America. And if we look at – we reorganized our company about 2, 2-1/2 years ago to become more market-led. And what does that mean? We organized it around the market segments. So we have a Biologics organization that is roughly around 20% of our business, the Pharmaceutical, the Small Molecules roughly around 30%, and then the Generics business is roughly around – again another 20%.

The balance of the business is what we call contract manufacturing. So a little bit different where we're designing scale in mass manufacturing of critical devices used to administer drugs such as insulin pens and start to think about continuous glucose monitoring devices for diagnostics in the diabetes space. So it's a very healthy growing business for us today.

I guess just to summarize, one of the growth stories of West is when we look at the construct of this business, on an average, we're looking at about 1% net price contribution, 2% to 3% is what we feel the market's growing on a volume basis for the injectable medicine space. And then the balance, what we call mix shift, about 3% to 4% growth to give you some 6% to 8% organic growth year-over-year for our business.

And we sort of think about mix shift, what's really important about that is our high-value products. And we're on this journey, and it's been it for a while. But there's a lot of runway ahead of us because the regulatory environment, the needs of the customers is the highest level of quality, zero defects, low particulate – no particulates in the product, and that's where we come in with a high-value product proposition.

So we're excited about where we are today. But more importantly, we've started thinking about the robustness of the markets we're in and the future we have. It's encouraging to see where we're going to go in the future.

QUESTION AND ANSWER SECTION

Daniel Brennan Q
Analyst, UBS

Terrific. Terrific. Thanks for that. So I know one of the beauties of your business is just the moat around your business, the fact that you've got these long-lasting relationships with your customers. You're designed in. The switching costs are high. Nonetheless, I did want to at least start off with a few questions on the competitive landscape just to make sure that I understand what the trends are there.

So, maybe could you just speak to how you would characterize the competitive landscape within each of your areas, maybe within each of your customer groups? I know there are a couple of large European competitors. But I'm just curious to see, has it been very stable? Have there been any shifts in the last couple of years? Do you anticipate any shifts going forward?

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

Yeah, Dan. What's interesting about our space is there's not a lot of shifting between one supplier or component provider and to the other because, as you mentioned earlier, when you have a drug that's launched in the marketplace, you are written into the regulatory filings and that switching cost is extremely high. We believe that we have the highest level of quality. Our service has drastically improved over the last couple of years. And so, we're in a very good position in that we don't really see switching between one player to the next.

We – with ourselves, West, and our partner Daikyo, which is a relationship over 40-plus years, it's a firm, a private firm in Japan. The combination of both entities we believe were approximately about 70% market share in the elastomer space for injectable medicines. There are two other competitors that are obviously much smaller.

We respect what they do in the marketplace, but we have a very healthy outlook. I think the area of competition when you look at the space is really in the pipeline. What are we doing to solve some of the unique challenges our customers have launching these new molecules in the marketplace? And those conversations are happening very early on in the process. If that conversation's happened during a launch or just after clinical, that's a problem.

And so, our focus is really driving really a few things. One is it's driving the quality. That's top of mind for our customers. It's our technical customer service capability where we're actually engaging with our customers and helping design what is the right formula for that drug, so the drug material interaction is very important to understand, which is West's forte. It's the service aspect. We have done a great job with our operations globally to be able to provide a very quick response to our customers. And with the recent investments, our bottlenecks on our operations have been dissipated.

And the fourth one, I would argue, is scale. Having scale does matter in this space because when you're on a molecule, you need to ensure to your customers that you're able to supply the material not just today, but 6, 12, 18 months down the road after launch has occurred. Roughly speaking, from a market segment point of view, as I said, we're roughly around 70%. I would argue in the biologic space, we believe we're a little bit higher than that. We're much higher than that. Pharmaceutical, small molecule, we're about at that average, and then generic, slightly less than that. That's how I look at the landscape today.

Daniel Brennan
Analyst, UBS

Q

Great. Within that growth algorithm which you let off concluding your opening comments, I'm just wondering if you could discuss the 2% to 3% volume assumption. Obviously this is over a period of time. It's not any one quarter or any year. But just as we move to more of these targeted therapies where a lot of it – the size of maybe the population is smaller, just what's the visibility on that 2% to 3% in any given year? How does this movement towards more targeted therapies maybe impact that 2% to 3%?

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

A

Yeah. So it's – there's some volatility especially in the areas of the Biologics space. You're absolutely correctly, we started thinking about some of the really unique solutions our customers are coming up with in the biologics, the amount of doses may not be as frequent as a small molecule or a generic. And but, what is when we play in that space, it's not just on a single component but more of a solution based approach.

When we look at the volumes, the 2% to 3% is on aggregate absolutely. We believe small molecules are less than that. The generics space where we believe from a volume perspective about mid-single-digit type growth looking into the future, and then biologics as mid to high-single digit from a volume perspective. So that's how we come up with the construct of the 2% to 3% volume.

But you're right. As molecules change on the frequency of dose, but while that's occurring, the complexity increases significantly, and the quality standards increase significantly. And that's why we are sort of thinking about our portfolio and we're driving more high value products up to our NovaPure which is the highest level of quality. That is a solution that ensures that these more complex molecules are able to get in the market and being safe and effective. But the economics are absolutely favorable for West also.

Daniel Brennan
Analyst, UBS

Q

And in terms of volume, and I'm sure this is a frequent conversation in all the one-on-one meetings that you're doing here in – it's only the quarter-to-quarter variability, right? And you've faced it and you've addressed it in certain customer segments and you continue to address it. But it's so worth just exploring further just maybe starting off with the generics space, just what exactly – the impetus of that variability, what are the actions you've taken, how broadly can those actions be transferred across your different business lines, just being sure to get an update there.

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

A

Yes, sure. So from a generics perspective, we have to go back a little bit in history. In the 2015, 2016 timeframe, we had – we saw a number of customers that were dealing with FDA issues and they were also taking steps to, as Eric said before, move up the value scale with us towards more of our high value products where we were – where they had been doing washing and sterilization, some crude washing and sterilization. And we were taking that over for them and also providing them with some vision inspections. Envision is what we call that.

So in those time periods, you saw the growth rates were 20% plus. And we know based on the construct that Eric just laid out for you, that that's way above market growth. Our lead times were expanding during that timeframe too as these customers would throw in more and more orders into our fixed base of capacity. Our lead time stretched from, say, 14, 16 weeks to, in some cases, more than 30 weeks which is unacceptable. So you had the situation of – it feeds on itself. Customers then needed to look at – okay, well, if I'm not going to get my product for 30 weeks to prevent a stock-out, I need to place some more orders in the queue.

We did some things to address the lead time expansion. We did some very good lean work in our manufacturing facilities specifically around the washing process, and we were able to get additional capacity out of our existing footprint. And we also brought on our Kinston, North Carolina facility to be able to have increased washing capacity down there.

So between those two things, we were able to shrink that lead time back down to the less than 20 weeks getting closer to the 12 to 16 weeks where we should be. And so now you have customers that had a lot of excess orders in the system that those were going to take some time to work down. So we saw that through the late 2016, early 2017 timeframe and today, we're working through those issues.

We've now kind of lapped that. We feel very, very comfortable and we saw good growth in Q1. We've got decent visibility to where we're going in the future with generics, and we feel that that's going to be a good solid, as Eric said, kind of mid-to-high-single digit grower for us for a long period of time.

Daniel Brennan
Analyst, UBS

Q

Was the impetus for that such that it could be used as a proxy towards maybe getting ahead of some other type of similar things? It could happen in some of your other businesses. Was the impetus that there was a certain high value product that suddenly became more available to the generics or was it a function that you had some branded drug, a couple of the timing of a couple of branded drugs that went toward generics so they were just full of support? I'm just wondering like what caused it at that point in time.

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

Multiple issues, really. So it's a little bit of everything. So remember that the size, the volume that you're talking about in the generic space with the small molecule generic injectables is very large. So to convert over, to have some issues come out of one customer to another, it causes a lot of demand shifting in the marketplace. You contrast that to biologics where the values of the drugs are very high, but the number of units are much smaller. It tends to be more lumpy. So we feel that those – there is many, many issues that impact us.

In terms of learnings from it, the most important learning is that you need to be close to the customer and while transparency in the supply chain is not something that's very high on the scale in terms of where this industry is compared to high tech or automotive, for instance, but we're moving in that direction.

Our supply chain people are spending quality time with our customers' supply chain people and there's becoming a little more transparency into what the real demand is, not just the demand based on plant needed to be upgraded or some 483 issues, but more transparency into what real underlying demand is.

And when you can get to that level, it creates a real win-win situation for both you and the customer. We get the win out of being able to have more transparency and, therefore, we can level load our plants, become more efficient. But also for the customer, you're able to reduce your lead times; you're able to help them from the perspective of you – they don't need to carry as big of a safety stock. Their working capital goes down; there's a lot less cost associated with carrying West. So it's a real win-win situation. So that's the real learning, is to be able to develop more transparency and be closer to the customer.

Daniel Brennan
Analyst, UBS
Q

And staying on generic, what have you pegged like your generic growth rate and how would biosimilars impact that growth rate and over like what timeframe do you think biosimilars are going to have an impact?

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

Yeah. So when we look at the generics, we're looking at more long term as mid- to high-single-digit type growth in generics. We are still talking about biosimilars. We actually look at that similar to the biologics business because the value propositions that were created for biologics are very much applicable to the biosimilars area.

Daniel Brennan
Analyst, UBS
Q

Right.

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

You're right. Biosimilars will be a catalyst of growth. And we're seeing that at this point, and we'll see it actually more momentum as you go over the next three to five to seven years in that particular space. But the attributes and the needs of the customer of the biosimilars, the complexity of the products, the molecules, requires again going on a high-value product journey for us.

Daniel Brennan
Analyst, UBS

Q

Right. And in terms of the volatility then that you saw also in the pharma customer base, I know, I mean I don't want to have to belabor the volatility quarter-to-quarter because I'm sure you guys always talk about it, but what was it different on the pharma space and is that now behind us?

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

A

Yeah. It's a little later. It was delayed a little bit versus the generics. It's the same kind of issues. I mean you have similar issues, regulatory issues, customer inventory management. I think the one thing we should back up and when we think about this, volatility happens over a quarter-to-quarter basis. But when you look at our business over long periods of time and start to take out some of the peaks and valleys, you'll see that it's a very, very annuity-light business. It's not [ph] nearly (00:15:59), but an annuity-light business where, as Eric described, we're on these customers' products because of the regulated nature that moat around the business for the life of the drug really. There's very little switching. We don't take existing drugs from our competitors. They don't take from us. It's really about the next generation of drugs.

So when you think about the volatility, you really have to do a couple of things. You have to look at what are the comps that you're comparing against. What has happened kind of over the last three, four, five, six quarters and try to translate out some of the oscillating curves of excess demand and less-than-normal demand because we will always, we believe, revert to that need.

So like I said before, first quarter of 2017 for the pharma systems, we had very, very strong growth in that quarter, way above what you would expect which is normal would be low to mid singles. So we called it out. Part of that was helped by Venezuela which went away when we deconsolidated it. But those are the things you have to do.

So while we will continue to have volatility in all of our business units, less so in the contract manufacturing space, but certainly in the biologics, we'll continue to have volatility, generics a little less so, the pharma as well. We just need to make sure that we're continuing to look at it over longer periods of time.

Daniel Brennan
Analyst, UBS

Q

Okay. And in terms of the biologics business, I know you cited customers more recently going on the last time the customer going from clinical to production. You discussed some inventory adjustments. It sounds logical certainly when you go from smaller batches towards like much bigger batches. But it's just the timing of that transition and maybe they're over ordering at some point and then again cycling through that. But specifically what was it about this issue?

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

A

So I think biologics, when you look at it on a quarter – same thing, when you look at it on a quarter-to-quarter basis, we're talking about an $80 million to $90 million recorded business.

Daniel Brennan
Analyst, UBS

Q

Yeah.

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

A

So you have a couple of customers who are either doing prelaunch or launch activities or have done that and now we're in the face of trying to assess out what the – how the market is accepting their new drugs in the marketplace. And you have an impact of a $4 million change in a quarter that's really big to a small business like this on a quarter-to-quarter basis. You have to again stretch out, look at it longer and longer periods of time. We've grown high value products which is the analogy to our – almost all of our biologic businesses, high value product, a big piece of generics and about a third of pharma. That's grown and part of the construct is 6% to 8%. That's grown over 10% per year over the last five years. In fact, when we look at it over the last 10 years, it's grown a little over 10% a year.

So we are doing this. We are growing. Customers are growing with us up that value chain and taking more and more of our product. Yeah. A little bit of price – market volume, but this mix shift is a really big thing and we work in conjunction with the customer to help them resolve some of those needs they are facing either from a regulatory respective or their own market moving desires to become a higher quality, lower particulate product. So those are some of the things that we look at to help us understand the growth rates of the long periods.

Daniel Brennan
Analyst, UBS

Q

So, certainly, the growth of injectables and you touched on earlier when you dissected it 2%, 3% volume just as the biologics and the pharma and the generics. But the growth of injectables is almost synonymous with the growth from West, and obviously, you had a lot of value on top of just the market growth, but I'm just wondering, when you look out, injectables as a class seems like they're only going to continue to proliferate, but maybe just speak to give us a little bit more color about what you see today from the kind of biologic drug pipelines and/or other alternative means of delivery besides injectables that kind of what kind of growth profile can we see just on injectable lines from marketplaces to look at over the next five years or so?

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

A

Yeah. Now, we are pretty comfortable as the injectable space continue to grow. We talked about the 2% to 3% type of volume component, and that's because of, just you look at the pipeline of new molecules coming through. And it does take time to get adoption into the marketplace and into the channel. So we started thinking about the five-plus year. We're pretty comfortable. You start think about what could disrupt the injectable medicine space. And that is an area that we continuously look at. Will it be a higher growth than oral, as an example.

If you start to think about some of our investments, and we're investing some of our research, we're really focusing on not just on the primary containment. That's where we have a very large share. It's also now in the delivery devices. So, we have we have a couple launches recently. Obviously, we're talking about SmartDose and SelfDose that have been launched into the marketplace, but also in our contract manufacturing space where we are producing a very large portion of the global demand of auto-injectors as an example.

And it's that continuum of primary containment to delivery devices, where it allows us not just to kind of grow at the market but actually creating more value to the marketplace by adding more features versus a component perspective. So we're pretty comfortable with the injectable medicine space having a nice continue – growth trajectory over the next number of five years.

Daniel Brennan
Analyst, UBS
Q

And we just heard at the lunch presentation a lot of commentary on drug pricing and I just wonder, while certainly the customers of yours may feel the impact on the drug prices, certainly how much of that would ever flow back to us but I'm just wondering from a high level, is that something that comes up during negotiations? Is there anything built in for drug pricing that might ultimately be a negative for you?

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

We really enjoy working with R&D and quality and manufacturing but you're absolutely correct. Some of the larger firms have a robust procurement organization, sourcing organization. And there is that question that does come up is how can we help drive some of the costs out of this system? The benefit of West right now, the direction that we're going with the investments we have made is that we're able to start – well, we do offer services and capability that our customers, in some cases, do themselves. And we can show them through a total cost of ownership approach, that bringing it in-house to West actually would ultimately reduce some of their costs.

So it's really a twofold to that question. One, is yes, we do get the price question frequently but if you think about our contribution again, we're doing about 1% on an annual basis at West. And typically, the costs of our materials going into a drug compounds, we use about less than 1% of COGS. So secondly is that conversation turns quickly back to our high value product proposition, is that by doing the washing, the Envision inspection, sterilization? Doing that with West, we can show that we can drive costs out of this system, the entire system.

Daniel Brennan
Analyst, UBS
Q

And touching upon the high value products portfolio, I know you've got some products that have been in existence for many years, others that are new. So you have very different penetration rates among them. But when we think about some of the newer products, I think there's a much higher level of price associated with those as well. So is there a way to think about what's happened over the last, say, 5 or 10 years at HVP? Could you see any of that growth which has been very strong even accelerate as some of those newer products have a much higher price attached to them begin to see increasing penetration? Is there a reason to believe the next five years can be stronger?

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

Well, I would say this. It takes the transition – we started with Westar 15 years ago, and our penetration rate is probably less than 50% right now in the marketplace. So it's taken – and it continues to grow. And so we started thinking about our most recent launch in NovaPure about a year-and-a-half, two years ago, that's plus 1% of our revenues today, growing very nicely, but it's off a very small base. But the adoption rate is going to take some time because you can think about it, it took us a year to invest in that capability, a year for validation.

Now it's taking our customers a couple of years for stability test and to prove the concept of moving some of the large molecules on to the NovaPure product portfolio. So there is that natural progression towards the NovaPure which, you're absolutely correct, has a more favorable economics for less when it comes to revenues and margins.

I won't commit to any acceleration. As Bill said, we've had double-digit growth for the last five years in high-value products. We do believe that is sustainable going forward. But you're right. The mix will probably be more towards Envision inspection, NovaPure-type capabilities which is more a favorable mix for us.

Daniel Brennan
Analyst, UBS

Q

I believe that, too, in terms of your portfolio, I know you've got a number of products within there. But if you had to – I'm sure they're all terrific and they add a lot of value to the customers. But if we were to think about a couple to watch that carry those higher price points maybe to the extent you were to see – we were to hear commentary from customers that they were adopting them, that could be certainly more of a step function, which are the ones to watch on that front? Is it NovaPure? Is it Envision? Are those the two? Are there any others on that front?

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

A

Well, I think it's twofold. One is if you're looking at customers with existing molecules in the marketplace today. They want to make the conversion to either solve a problem or they want to have a new platform approach. You're going to hear more about, again, that 40% or 50% Westar type penetration. You'll still hear about that growth being attractive for us.

When you start to think about the biologics, and especially the emerging biotechs, where they're looking for a whole quality by design concept and have documentation that supports the characterization of the product that they can file along with their requests, that's where you get into the NovaPure. And so absolutely when you start to think about Envision and start to think about NovaPure, the high growth that we expect, that we're seeing, that we continue to expect to see, I wouldn't say that you're not going see as much growth in the base of the Westar.

Daniel Brennan
Analyst, UBS

Q

Right.

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

A

And the RU and RS, what we call, so it's going to be a mix.

Daniel Brennan
Analyst, UBS

Q

Can we switch over to the free cash flow profile and CapEx for the company? So can you just discuss where we are? And then you've got a large global manufacturing footprint. You have some expansion ongoing within existing facilities and then some new-build.

But where are we with the evolution of your CapEx? And are we at a point where you are going to be able to see that? I think it is moderating. Maybe free cash is going to start expanding. And if that's the case, how do we think about free cash flow conversion in kind of cash deployment?

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

A

Sure. It's a great question. So absolutely – so we've gone through a significant amount of time where we put – and we have over $1.7 billion invested in our facility, so it's not insignificant. And in fact, we have in our construct, we look at $150 million to $175 million per year as being kind of the target range for our capital.

Last year, in 2017, we did about $130 million. This year, we're suggesting we're going to do less than $150 million. So we are certainly on the low end of that range that we looked to and that's driven by things like we had. We just put up the Waterford, Ireland facility which is a major undertaking, $130 million with the capital we deployed there, but will give us tremendous amount of growth, basically a blank canvas which – upon which to write the future story of West as it relates to high value products both from risk mitigation to our sheeting facility in Denmark for insulin, but also to high value product conversion for finishing of our high value products in Ireland. We did, also Kinston too was expanding.

So we've got a lot of footprint that we've taken where we've got excess capacity right now today. And you've seen the negative side of that and through less-than-stellar overhead absorption. But what it creates for us though is as I mentioned is this ability to take additional capacity from our customers and be able to do it at a very incrementally, marginally better rate. So we feel very, very good about that.

Your point about the impact on operating cash flow and then free cash flow is absolutely correct. So as we go through the construct and are able to expand sales in that organic 6% to 8% range and throwing off good margin expansion associated with that growth rates in high value products primarily, we're going to see operating cash flow grow as we have but we'll continue to see it grow. If we can keep pinned down that level of CapEx into that even below the $150 million to $175 million, we're going to definitely throw off a decent amount of free cash flow as we suggest we will this year and going into the future.

Our capital deployment, our capital allocation strategy is fundamentally sound. We haven't changed it within the last few years and we don't see any reason to changing it in the near term. Invest back in the core of the business is our first order of business especially as it relates to high-value products. Second thing is we pay a dividend. We've done it for 25 straight years. We're going to continue to do that. A lot of our institutional investors hold us in their dividend fund. That's about $40 million or so.

We're going to continue to pay down debt as we see the debt mature or as we see opportunities to take it out at a favorable rate as we do today. The rates are starting to come up again, so our fixed debt has a not so terrible replacement costs associated with it. We think about buying back, yeah, buying back shares. We have a board authorized 800,000 share buyback program that's currently ongoing, and we see a good opportunity for M&A especially bolt-on M&A in the technical side of our business for devices especially. So that's kind of the order of priority for our capital deployment, and we'll continue to do that, we think, into the near term for sure.

Daniel Brennan

Analyst, UBS

Great. And with that, we're out of time. So thank you all for coming. And gentlemen, thanks for being here with us.

William J. Federici

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

Thank you, Dan.

Eric Mark Green

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

Thank you, Dan. Appreciate it.