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West Pharmaceutical Services, Inc. (WST)

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MANAGEMENT DISCUSSION SECTION

Juan E. Avendano
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I am Juan Avendano. I am part of the life sciences tools equity research team led by Derik DeBruin of Bank of America. I focus on biopharma services, namely CROs and CDMOs. I'd like to thank everyone on the webcast for their participation. And please feel free to submit your questions through Vericast.

It is my pleasure to conduct the following fireside chat with West Pharmaceutical Services. We're joined by their CEO, Eric Green; their CFO, Bernard Birkett; and Quintin Lai from Investor Relations. Eric and team, hi. Thank you once again for being here.

To set the stage, would you like to do a few opening remarks?

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

Yeah. Juan, first of all, thank you for the opportunity to participate in your event. It's been a really good day for us. And I'll just add a couple of comments before we get into the Q&A. But when you think about since the start of the pandemic, our priorities have remained constant. We think about safety of our team members across the globe, and also continuity of supply of the critical components needed by both our base customers, but as well as the dynamic demand by our customers working on vaccines and therapeutics.

I won't recap on 2020, but I'll kind of fast forward to Q1 of 2021. We continue to see strong high-value product growth in both our base business as well as accelerating demand of components used for COVID-19 applications. The high-value product sales growth led to strong gross and operating profit margin expansion. And we're very pleased by being able to leverage our operations globally as a network more effectively today than I would say what we had in the past.

We're also completed with our first phase of capital expansion. We added capacity, started to inject into our operations at the end of 2020. And [ph] obviously (00:02:23), validated and now, we're able to produce commercial product. We're almost completed with the first phase.

Second phase is occurring through the back of 2021 and into 2022. And then we're currently under another consideration of another phase as we gain more visibility, and really two key areas. One is productivity gains for our first two phases and also sustained demand of COVID-19, which would mean that we'd need more capacity to address our growing underlying base business.

Just to summarize, though, the focus of the organization is really around execute, it's around innovate, and it's also around growing. I believe the organization is performing quite well at this moment even under these uncertain times. So, I'll end with that one. I hope it's just enough context about where we are today. And I know Bernard and I would – and Quintin would like to field any questions you may have.

QUESTION AND ANSWER SECTION

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

That was good. Thank you, Eric. Appreciate the opening remarks. So, let's just go ahead and dive right into COVID-19. In the initial rollout of COVID-19 vaccines, it has been generally carried out in multi-dose vials. But based on comments during your last earnings call, in line with our channel checks, there is a chance the future of vaccine doses and potential booster shots could be administered in fewer dose vials and even single-dose prefilled syringes. Could you provide more color on this evolving dynamic? What is the potential benefit to us? And ultimately, what are your thoughts on how durable the COVID-19 business could be?

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

A

Yeah. You're right. In today's environment, the COVID-19 vaccines are administered in multiple doses as you rightly said, ranging anywhere from 5 to 14 doses per vial. And our business, we're really focused on number of units versus per dose.

And the situation continues to be dynamic and fluid. Everybody knows that the vaccination rates are still ramping or yet to be ramped in certain countries across the globe. And we are – and yes, we are hearing that boosters and annual shots through conversations with our customers may be required in the future. So, these could be developed and packaged and that looks more like flu than the mass vaccination strategies what we see today. And therefore, you're looking at less dose per vial or being packaged in a prefilled syringe format.

And I'll give an example, when we think about the typical flu shot today in the marketplace comes in various forms such as prefilled syringe, one for the adult, and the one for the children age. We have single-dose vials and we have multi-dose vials. So, the configurations could change from what we're dealing with today and could be quite different. So, we believe based on what we're seeing and work with our customers that that change will occur. But it's going to take time and hence the discussions we're having internally on what additional capital would we be required to put into our manufacturing facilities to handle a potential increase in demand.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Good. And I believe the majority of your COVID-19 business is related to vaccines. But can you give us an update on what is going on with the packaging component sales related to COVID-19 therapeutics? Have you seen a slowdown since the vaccine rollout?

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

So, there hasn't been much of a change in regards to therapeutics. So, we're, obviously, still participating on all the therapeutics in the marketplace. But you're absolutely correct, majority of the volume that we are currently producing and shipping to our customers is around the vaccine [indiscernible] (00:06:22).

Juan E. Avendano
Analyst, BofA Securities, Inc.
Q

Good. And, sort of, like the topic [indiscernible] (00:06:28), lately – I mean, last week, it was reported that the US would support waiving patent protections for COVID-19 vaccines. Can you give us your thoughts on this matter? And could this have any potential follow through impact from your customers onto West?

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

Yes. It's difficult to comment on the, I call, hypothetical policies and I know that that's only been discussed for the last week. From our perspective, when you think about our materials, we are the global leader for elastomeric primary packaging for injectable medicines. And we work with customers across the globe, ranging from large pharma, generics and emerging companies. And it really is around the science, quality and scale. So, you think about the compatibility of the drug molecule with the primary packaging containment. And the – we – that's what we're focused on, that's what we can give assurance to our customers. But in regards to the IP discussion, it's hard to comment at this point in time.

Juan E. Avendano
Analyst, BofA Securities, Inc.
Q

I understand. Moving on to the financial performance and guidance of the company, in the first quarter, West generated $103 million in COVID-19-related revenue. Even when you exclude the $12 million one-timer fee that you called out in the earnings call, your current guidance, which assumes $345 million in COVID-19 revenue this year, implies no sequential pick-up in quarters to come. So, can you help us understand why is this the case when COVID-19 vaccine manufacturing activity scheduled to increase as the year goes by?

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

I'm want to pull Bernard into this conversation. So, Bernard, could you address that?

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

Yes, sure. We're giving guidance based on what we're seeing in our business at the moment. And, we think that that $345 million number is pretty solid. Then there's a couple of factors that we're kind of baking into that as well as when we look out at Q3 and Q4, and then particularly, those quarters from a revenue perspective, it's sometimes a little bit lighter for us because we have plant shutdowns particularly in Europe for a number of weeks in August, so as we maintain our plants, so there may be a slight drag there. And then again, in December timeframe, you've got less production days, so you got to bear – take that into account as we move into the holiday period. And so, we've been factoring that in.

Now, if there is greater demand than what we have forecasted, we have the capacity put in place to be able to meet that based on the earlier comments about layering in capacity in various phases with some of it coming on board in 2021 and then the rest in 2022. So, that was the thinking behind the guidance. We just didn't take a number from Q1 and extrapolated out over the year. There were a number of different factors there. And plus this whole situation in response to vaccines is evolving as we speak. So, I think it was kind of prudent to guide in the way we have.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Thank you. I appreciate that. And then, you've spoke a little bit about capacity, and so, let me just go ahead and jump on that topic. And so, you've had to expand manufacturing capacity in order to support – for high-value products in order to support COVID-19 demand. You've hinted at this, but can you just give us a quick summary of your capacity expansion plans, what's been completed, what's still in the works. And how should we think about CapEx as a percentage of revenue on a normalized basis going forward?

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

A

So, the way we looked at CapEx particularly in response to this pandemic, we've done it on a phased basis. So, we started last April in 2020. We looked at how the market was developing and how vaccines were being developed. We put extra capacity in place particularly around FluroTec, where we saw a lot of interest and around NovaPure. And that capacity we started layering in towards the back end of 2021. But the equipment validated and [ph] some of it (00:10:58) was actually in production by the end of the year.

We're continuing to finish that first phase. And as we got to the back end of 2020, we came to the conclusion that we needed to add more CapEx, particularly for the latter part of 2022 and into 2023 based on what we're seeing. And again, it's not just for vaccine business. It was really to support our core growth, which we were seeing in those specifically around high value products and then the vaccine element on top.

And we're really layering in replicating equipment that we already have in place. So, we're not adding any new technology. So, it's pretty straightforward for us. It's just the speed that we're operating at and the volume we're putting in at the one time. And again it is all equipment. It's not bricks and mortar at this point. So, it had been pretty quick and it's been right across our high-value product plans across our network, so – in multiple geographic locations. And so, at this point now, we're looking at – potentially looking at Phase 3 based on some of the comments that Eric made earlier about how the market is evolving, how vaccines will be – could potentially be delivered in the future.

So, we have to assess that. We haven't come to any conclusions yet. We're working that through. So, that's why – how we've managed it, so our CapEx as a percentage of sales has peaked in 2020 and in 2021. On a normalized basis, we typically see about 6% to 7% of revenues being deployed on CapEx and to support growth within our normalized construct of about 6% to 8%.

But also, one of the things that we have to kind of understand as well is the growth profile of our business has shifted over the last couple of years, where we had seen double-digit growth in contract manufacturing for a number of years, and then probably less than double-digit growth in our proprietary business.

Now, we're seeing [ph] both (00:13:06) our core business and vaccine-related response, biologics has become the main driver of growth within our business. And [indiscernible] (00:13:16) and so, that along with the kind of normalized growth we've seen in Generics and Pharma leads to a different mix shift and which has kind of helped us decide on where we need to deploy capital and to generate faster returns.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Thank you. On one point that you brought up that essentially Biologics being a major driver of [indiscernible] (00:13:44) reason as to why you're adding capacity. Could you break up the component that is associated with new product approval volumes versus conversion within high-value products that are going through Biologics based on what you've seen recently?

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

A

Well, within – I can start, Eric, and then maybe if you want to [ph] comment (00:14:08). Within Biologics, it's primarily all new business, and it's predominantly around high-value products. So, as soon as somebody enters that space, they're going onto a high-value product. And what we're seeing now is that more and more people are gravitating towards NovaPure towards the higher end of that spectrum.

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

A

Yeah, and the first – when we think about the first four months of this year, we mentioned that we're over 95% [indiscernible] (00:14:38) rate on the new Biologics [audio gap] (00:14:41) approved in Europe and also in the United States, and Bernard is absolutely correct, as you think about the [ph] seating (00:14:48) of NovaPure, we started that journey back in [audio gap] (00:14:53) 2016, 2017, it takes about two years to really – to penetrate into the new pipeline. So, we do start early.

And we're seeing the benefit now. And that's where the demand is picking up. So, it's also – it's new drug launches but it's also we're seeing our customers' drug molecules getting a higher acceptance rate into the market. And that's growing also. So, it's kind of a compounding effect. So, we're very pleased with the pull effect that we're having right now, particularly in Biologics with the high-value products.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Understood. And has there been any specific regulatory tailwind that that has sort of supported the high-value product conversion or how do you see trends in the regulatory landscape in the packaging space?

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

A

Well, it's in our favor, frankly, when the regulatory landscape gets more complex. I mean, I know there is obviously some changes that are underway with USP. I think about particularly around – I think it's USP 381 is getting again specific here, but the physical chemical series, and what this is all about, it's really functionality testing must be looked at from a system approach and based on the actual drug application.

So, this benefits us and really – and we think about it in two ways. One is all testing must be complete on the components and they're finished [indiscernible] (00:16:25) ready to use. And you've heard us talk about Westar

RU, NovaPure RU that's ready to use. So, as we continue to introduce these products to our customers, they're already in that format, which allows easy adoption with these regulations.

And the second is really we have – just over my shoulder actually, we have a very robust analytical service laboratory, which we can help facilitate this kind of qualification testing for our customers. And this really simplifies our ability to get drug application-specific testing completed and filed. So – and that's what West – it's one of the core competencies of West and we are able to differentiate on that. So, you're right, as – there's other regulations like ISO standards and ICH guidance, they're all – they're changing but that is in our favor. And as we develop our high-value product portfolio, we're able to encompass those requirements and make it much more of a value proposition for our customers.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Thank you. Going back to guidance a little bit, I mean, your base business has accelerated significantly. West delivered 10% organic growth in 2019 and 11% organic growth in 2020, excluding COVID. Do you believe that your long-term target of 6% to 8% organic revenue growth is still appropriate? Why or why not?

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

A

I'll let Bernard address that one.

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

A

Yeah. It's still appropriate. I think when you look at the growth trajectory of the various parts of our business, [ph] it ties a (00:18:05) – it gets us to that 6% to 8%. So, if we can do greater than 6% to 8%, great, we will, obviously, strive to do that. But as I mentioned earlier as well, our CM business, what we were seeing double-digit growth, that's going to come down, that is a mid-single-digit growth and that's where we'd expect it to be.

Our Pharma business is typically low-single-digit to mid-single-digits, Generic mid-single to high. And then Biologics is high-single-digit to double-digit growth. And so, when you combine all those factors at the moment, we're seeing that – on a normalized basis, if you strip out COVID, you're getting to that 6% to 8% growth rate.

And then the other thing you got to consider, this is – that 6% to 8% is of much larger numbers than it has been asked. And even if you look at the acceleration over the last, like, one to two years, the step up in revenue has been pretty considerable. So, to grow to 6% to 8% of that number is – it's something a little bit different.

Plus with the opportunity to continue to expand operating margin by 100 basis points plus, again, on those larger numbers is – we're confident in our ability to do it and we're confident in the 6% to 8% in the long-term outlook with that. And at this stage, to, kind of, commit to anything higher, I don't think is – it's not the right time for us.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Understand. Moving on to the cost structure, inflation and margins, given the last [indiscernible] (00:19:48) that you had, you've done quite well on margin expansion. I mean, West expanded adjusted operating margin by 330 basis points last year and could do even better this year. So, I have a couple of questions on this. First, are you seeing any notable margin pressures from labor, logistics or higher elastomer raw material costs from the increase in oil prices? And can you pass all of these costs onto your customers or what proportion?

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

A

So, on the labor front, there are some pressures with labor. I think it's well documented. To this point, we've been able to hire the people we needed to hire. And that's globally, so at each of our plants, we've been adding head counts as the volume increases that have been going through. So, we have very, very strong HR network in place to be able to attract those employees, onboard them. And plus, when we're bringing people onboard, it's really people understand that the importance of what we at West do and how we're supporting the pharma industry. So, that's kind of an added advantage when we're getting people to come onboard.

On the wage inflation side, we have seen that in certain locations, and we've been able to offset that with greater levels of efficiency and productivity, and also by being able to run some of our plants in certain areas within those plants 24/7. We're getting better operating leverage. So, that helps us offset some of those increased costs.

On the materials side, yeah, there are increases. Some of them we can pass on to customers [indiscernible] (00:21:38) after a 90-day period, so it rolls for a quarter and we pass them on. And then we have some hedging instruments in place around some raw materials, particularly oil based. So it's – these are just other challenges we have to manage. I don't see them being overly material having an over – a negative impact on our margins as we move forward.

And that we've been able to absorb them. And we've also absorbed the increased costs around logistics, around PPE, around keeping plants running 24/7 throughout the last year. And it's really again how efficient we can be through our plants helps absorb some of these.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Thank you. And on this topic, last week – I mean, Aptar, one of your competitors, actually announced a 5% price increase across all their product lines in order to offset inflation and raw material costs and labor. For West, what magnitude of price increase is embedded in your 2021 guidance? And what's the upside potential to this projection?

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

A

So, typically, we're 1% to 2% for price. So, we don't get price on all aspects of our business. We get it in certain sections. Within those segments, it's going to be north of that, obviously, 2%, on an average 1% to 2%.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Good. And then lastly on the margin profile [indiscernible] (00:23:10), outside of margin expansion that you typically get through your high-value products [indiscernible] (00:23:16) one point that might not get so much attention is the solid margin improvement in the Contract-Manufactured Products segment that happened over the last year. Can you remind us about the opportunities and initiatives to drive margin expansion in this segment? And how could the segment's – how high could the segment gross margin ultimately go?

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

A

Yeah. I believe the opportunity for margin improvement within contract-manufacturing, it's going to be less than what we – what's available to us in our proprietary business just by the nature of the business. We've said in the past that if we got to 19%, 20% margin on that business, I think that's where it can go. We've made a lot of improvements over the last 18 months in getting closer to that number, but there's still some work to do in that area, and it's really around increased levels of efficiency in automation. But, we're on the right track, and we have been making the improvements. So, we expect to see that continue. I would see more of that in the second half of this year rather than the first half.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Okay. Good. Moving on to the balance sheet and capital deployment, I mean, West has a very strong balance sheet, with a net cash position that is growing faster as your revenue growth and profitability have picked up. Aside from organic investments, CapEx, the dividend and buybacks, what else do you plan to do with this cash?

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

A

Well, there's not a lot left after doing those three things. For me, M&A has become a greater focus for us. It was important for us over the last number of years to really get consistent and have sustainable growth within the core business, organic business. And, we have done that and delivered the increased levels of profitability at the same time. So, now, we are going to look more at M&A. But, we're in a position where we don't have to rush in to do it. We still got a very, very strong organic pipeline, and that's our main focus. We don't want to do anything that would destabilize that.

So, we're looking at a couple of different options and a couple of different areas, how do we support our customers on the packaging side, are there other supports that we can give them and provide them with better service and products.

And then also looking on the injectables and wearable sites, there are areas that we can start to explore in more depth at this point. But it's really making sure that we go after the right targets. And when we do that we can create value from them rather than just doing an acquisition for the sake of doing an acquisition, we don't need to do that.

And so, I think given the strength of the organic growth story and the balance sheet, it's prudent to again take our time and wait for the right opportunities. And when they present themselves, we'll be ready. Go ahead, Eric, if you want to add more to that.

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

A

I think that was well said.

Juan E. Avendano
Analyst, BofA Securities, Inc.

Q

Thank you. Switching topics a little bit, I mean on to ESG if we may. I mean, many investors are increasingly using ESG criteria to make investment decisions. What are some of the ESG attributes of your company and ESG initiatives that are being undertaken?

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

A

Yeah. No, Juan, it's – there's much more discussion going on today than the past. You're obviously correct. And when we talk about the One West culture, it encapsulate many things including continuous improvement basically in everything that we do. And also being a great team member amongst one another and then create a great workplace to work to give back to our communities.

In other words, it really is – we believe that West should be a strong corporate citizen and ESG exemplifies many of these aspects. In 2017, we created our first set of five-year ESG initiatives. And we announced that we exceeded those goals just in three years. And so, end of 2019, early 2020, we relaunched, reset the next five-year targets, with even larger expectations. And we're confident we're making good progress towards achieving or exceeding those targets, particularly at around waste energy and water usage.

When we think about – we continue to reaffirm our commitment towards the One West team, value that calls really on all of us to respect one another, drive collaboration, embrace diversity inclusion in our workplace. And we do make – we continue to make strides in this area throughout the whole organization, from new team members being hired at all levels in our manufacturing sites to diverse representation, really, and our executive leadership team here at West.

So, we are releasing our corporate responsibility report in a couple of months and there'll be even more information provided later this year. So, stay tuned. But it's – I can assure you ESG has been, and still is part of the DNA of this company.

Juan E. Avendano
Analyst, BofA Securities, Inc. Q

Thank you. That is very important. And I just – one last closing question, this is going to be on competition. And so, one of your competitors has made remarks on gaining share during the pandemic. How would you compare your competitive position in the market share now, in relation to what it was before the pandemic? And also, do you see any structural changes in the market post-COVID, that could either benefit or impact West?

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

Yeah. I won't comment on competition, but I will say that we remain focused. You know that we launched the market-led strategy a few years ago. And that is really taking shape. We continue to make good progress with [indiscernible] (00:29:39) present and the future needs of our customers, their patients.

And you mentioned this earlier, the rising regulatory standards across the globe. So, I think we're very well positioned. One of the barometers we use here internally is what's your participation or win rate on new molecules that are being launched, whether it's small molecule or large molecule, it could be a biologic, it could be a biosimilar, I mean, it's very, very high. In fact – and I've kind of articulated more recently, but the numbers continue to go north.

So, that tells us that we are resonating with our customers of the value propositions of the new launches, the extensions of our products and driving service and driving quality and driving that assurance when they put that drug molecule on the market with our product, they're assured of the highest level of standards in industry. So, that's what we're focused on.

I think the pandemic has driven by more agility and it has allowed us to leverage our global operations more effectively. There isn't anybody in the space that has much volume that is going through the plants as West. And we're able to leverage that more effectively today than we were in the past because of the – I got to say driven by a lot of the pandemic decisions that have been made.

So, I'll stop on that one. I know we're out of time, but hopefully that addresses your question.

Juan E. Avendano

Analyst, BofA Securities, Inc.

Yes, you did well. And with that, I mean, Eric, Bernard, and Quintin, thank you once again. And for everybody on the webcast, thank you for your participation. And we would appreciate your support in the upcoming [indiscernible] (00:31:23). Thank you.

Bernard J. Birkett

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

Thank you.

Eric Mark Green

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

Thank you, Juan.

Quintin John Lai

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

Thank you.