GUIDEPOINT INSIGHTS

West Pharmaceutical Services: Former VP of Sales Operations on Destocking Concerns (30-Minute Teleconference)

Former Executive | Moderated Call | Moderator: Leroy Rogers | August 08, 2024 | 20 Min Read

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Laurent Frechin, Former Vice President of Sales Operations - West Pharmaceutical Services

KEY QUESTIONS

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- customers? Is there any way to speculate as to why visibility is so poor here, and why this has been an ongoing
- issue for longer than we expected?"
- "When you hear 8-12 weeks, is that a normalized level of lead times or do you think lead times need to go down further?"
- " How much do manufacturer lead times influence or drive the pharma companies ordering

HIGHLIGHTS

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Leroy Rogers: Good morning, and thanks everyone for joining us today for our call around West Pharmaceutical with Laurent. Before we get started, if anyone in the audience has any questions, you can email me at lrogers@guidepoint.com, and I'll be happy to pass along those questions to our advisor on an anonymous basis.

With that, let's begin. Laurent, it's a pleasure to have you here today. Would you mind introducing yourself and giving us an overview of your professional background?

Laurent Frechin: Yes, sure. I will do so. Good morning, everyone. I have been working on the primary packaging for pharmaceutical industry for more than 30 years, including 28 years spent at West Pharmaceutical Services in the commercial organization. I grew up in this organization, and my last two most relevant position was Vice President of Sales for Europe, leading a team of 40 sales director, account manager and customer service people.

Then after, the second major role was the Vice President of Global Sales Operation. This role really consisted in managing the sales process from managing the opportunity pipeline, managing the forecasting system on our 24 most horizon, and building all the sales processes able, really, to maximize the sales operational efficiency and efficacy. That's, in a nutshell, what I have done during all this time I've spent at West.

Leroy Rogers: For a bit of context for this call, last month, West Pharmaceuticals reported earnings and they cut their guidance. That cutting guidance was driven by continued pressures in customer destocking. We've been monitoring this destocking trend for a few quarters now. We were expecting destocking to improve.

To set the stage here, are you surprised that there hasn't been any improvement in the destocking activity of customers? Is there any way to speculate as to why visibility is so poor here, and why this has been an ongoing issue for longer than we expected?

Laurent Frechin: Before starting and answering this question, I think it's important to really describe a little bit how the primary packaging industry is closely linked to the pharmaceutical industry. What is very unique is that when you are supplying a pharmaceutical company with primary packaging components or injection devices, what you are supplying to this customer is the part of the drug. The relation between the supplier and the customer are very, very tight, very, very close.

When you are in this business, you are not running 100 meters, it's more a marathon that you are running. What is really incredible is that some of today's customer of West Pharma were already customer of West Pharma 100 years ago. There is really a very close intimacy between the two parties. The main reason is that the pharma industry is really looking for a very, very reliable partner. They want a company with financial stability, with a global reach in terms of production. They want a company with a manufacturing network able to provide capacity stability.

When you see what is happening currently, I think it's not really a surprise. The market was really completely destabilized with the pandemic and the race which started in developing vaccines for the COVID. It was really incredible, the pace and the speed, how fast companies have been able to put vaccines for COVID on the market and how fast, also, the industry has been able to react.

The pharma market, it's a very, I would say, stable market with a steady growth. If we look on the pharma market, we can talk about in terms of average growth, maybe 6%. When you look on the global pharmaceutical market, when you look on the injectable part, the growth is really faster. Which means that the supplier of the pharma industry really plan investments to really follow and support the growth. They are doing that for a long time in a very steady manner.

With the COVID, the surge in demand was so high that the market really came to a very tight situation. We had bottlenecks in the production. It was a race for the pharma company, really, to find a production capacity for the active ingredients, for the packaging materials, for the contract feeding. The industrial really started to really react.

This started, really, in the early 2020 when, really, the first company were trying to secure a supply for the vaccines. The market and the pharma company realized that the situation would become very tense, and every company really started to increase their order. The vaccines manufacturer, they were building inventories for raw material, they were booking capacity for fillings.

Everybody was trying to really get the full capacity. It was really a fight for capacity, a fight for demand. This was true for the company working on COVID vaccines production. It was also for all the other pharma companies.

The situation was such that every company were trying to contact their supplier to secure the supply of primary components, the supply of capacity, the supply of related services. It was really creating a real surge in demand and, also, we could really see a snowball effect because the company wanted to secure their productions and to make sure that the capacity that they were normally using with their supplier would not be consumed by the vaccine producer.

We could really see an increase in the inventory level for the pharma company producing vaccines, but also all other companies. When this happened, you see the order book really increasing for the supplier of this pharmaceutical company. The more the order book is really growing, the more the lead times are increasing because you start to create bottleneck.

When you have to add new capacity in this type of business, it's really taking time. A mold could be 6 months, but if you need a press, it could be 12 months. If you need to build the new plant, it could be 24 or 36 months. It takes time to increase capacity. What it has really created, because all the suppliers of the pharma industry, they are always anticipating investment. They are not reacting when they have the demand because in this case they are really in trouble because of this long lead time that you need to add capacity. They have really used the capacity that they were planning to install. They have accelerated their plan and they have continued to invest.

Anyway, when you add lead time really increasing from a normal lead time for a primary packaging component for the most basic one could be probably two months and it could go up to six months for the most sophisticated one. It has really increased the lead time and creating this snowball effect.

Then you have, really, this bullwhip also in the supply chain. Everybody's ordering lead time are increasing, so then people are placing even more orders. The time that the new capacity really come on stream, it's really creating this overeating. That's really what has happened with COVID. It's not the first time that this phenomena happened.

We had exactly the same situation when we had the swine flu. It was probably 10 years ago or even more to a lower scale, but when you had this H1N1 pandemic and also all the vaccine producers building inventories, asking for more products, suppliers creating capacity, when everything was really available, when also the demand decreased, it has taken some time to see this level of inventory decreasing.

What we are experiencing now, what we see with COVID, it's really something which is understandable. I think it was also something that we could expect. We have seen, really, the demand and the growth nearly doubling compared to the normal level.

I think we will go back to a normal or to a pre-pandemic level, to what I believe and I think, by the mid of 2025, we should go back to a more normal pattern with really growth in around 5%-6% a year or things like that. But not really what we have experienced with the COVID and it's exactly what we see with Pfizer with a sales decrease of 40% between 2022-2023. I think it was a pandemic, it was a surge, but now it's not surprising that we are going back to a more normal situation.

Leroy Rogers: You touched on a lot of points there, Laurent. I'll try to piece through all of them. One thing you talked about was lead time. On their recent earnings call, West talked about, at one point, their lead times being 30-50 weeks.

Now they've reached a level of what they call consistency in 8-12 weeks for lead times for their Westar products or their HVP-type product lines. When you hear 8-12 weeks, is that a normalized level of lead times or do you think lead times need to go down further?

Laurent Frechin: 8-12, sorry, it's really the normal standard lead time for manufactured products like a rubber component for primary packaging. After that, the more basic product, you can have a lead time of eight weeks, but the more sophisticated one, because of the process that you are using, because you need to get them washed, sterilized and so on, it could be longer. 8-12, yes, that's the average, but for more sophisticated products, it can be a little bit more.

Leroy Rogers: How much do manufacturer lead times influence or drive the pharma companies ordering patterns? I want to understand that relation a little bit more.

Laurent Frechin: When you are in a normal situation, when you have a lead time, let's use these 8-12 weeks lead times, the pharma company, they are really planning their production. For commodities, they are really working with just-in-time and getting the product. There, for the primary packaging, it's not a commodity. Really, depending on the lead time of the product they need, depending on the supply chain, is it a simple one, a complex one? They will decide, they will place their orders.

The pharma industry is a very conservative industry. In their key business requirements, number one is really the security of supply. It means they want to make sure that the components that they need, the component, which is a part of their drug that they are selling, will be available for their production because the cost of producing or developing a new drug, if you search, it's probably $1 billion. When they can really supply and sell, they do not want to have any disruption in the supply chain. They are really keen on getting that.

The second big requirement is, of course, the compliance and the quality. If the product is stable, it's something that they take into account in their ordering pattern. They always build inventory at different levels. You will have inventory on the primary packaging, on all what is entering in their cost of goods, so the raw material, the packaging components, the vial. All what they need to produce, they would have inventory at this level. How much? What quantity of inventory there is really depending on each pharmaceutical company policy.

It's also depending on how dependent they are from their supplier. If they are in a single sourcing position, they will increase their level of inventory. If the product is critical, sensitive in terms of quality, they will also increase their inventory. They do inventory for the primary packaging. They do inventory on the semi-finished product, which is a vial which is sealed.

Then after, they have, also, inventories by market, by country. You have really a lot of working capital in this part from what they need to produce. On the semi-finished product or the finished product, they are used to always have inventories. Very often, you see movements in their policy.

Today, we are running this post-COVID situation, so it's a post-trauma situation. I think all the companies try to recover. When it's really in a normal situation, when they have inventory, if the company needs to improve their working capital, they will decide to reduce their inventory, maybe from six months to three months. It's very seldom to see a company who has less than three months inventory at every stage of their production.

You see the relation between the inventory and the lead time. If you have a stabilized supply chain with a normal lead time, they will not really boost their inventory. If they have very long inventory lead time, if the supply chain is complex, then they will increase their level of inventory.

Leroy Rogers: Thank you for explaining that. Earlier, you talked about some customers having a 100-year relationship with West Pharmaceuticals. How much visibility does West themselves have into their customers' inventory levels? Do they have direct insight into those months of inventory on hand that you've referenced, or are they going by historic demand, and phone calls with the purchasing teams, and supply chain teams at these customers?

They don't actually have direct access to the customer inventory levels if I'm understanding all this correctly; they have to go by what their partner at the company tells them about how to think about how the company might order from West in the upcoming months.

Laurent Frechin: Yes. In the way you are managing the relation with a large customer, when you are a supplier of the pharma industry, and because of this very close relation, because of this intimacy and dependency, there are a lot of exchange with between the supplier and the customer at different levels with the procurement team, with the quality team, with the operation team. Very often, between the major supplier and the customer, they have a quarterly business review where they will check everything from the development pipeline to the supply chain, the order book the quality, the development, so everything.

Forecast is always a part of the discussion. I mentioned that I was involved in this process, and what is sure is that the pharma industry shares information with their supplier. It's an industry which is open and not really scared to share information. They like the transparency with their supplier, but they're also offering some view on what they are doing.

Typically, something which the pharma industry will always share with their supplier, if they have a product in the pipeline, they know that the product will be successful, they are already increasing the capacity for feeding and producing a drug, they will, of course share this with their supplier.

Because very often, the investment that the supplier of the pharma industry are doing, there are investments which are really specific to a customer. You have a standard product, but you have a lot of products which are specific to customers. Then the pharma industry will share with the supplier. They will say, "Ok, in three years from now we will have this, and this. That's our four, five-year forecast to really help the supplier to build the capacity and have the right plan." The mid-term, the long-term, you have a lot of exchange. The short-term horizon, which is more, I would say, 12-24 months is really more going with ups and downs.

Even if you have regular reviews, sometimes, when a pharma company will decide to reduce their working capital and decrease the level of inventory, they will give information, but you would have no pre-warning, so it's really something that you will have to deal with without big surprise.

They are a conversation, but anyway, a forecast remains a forecast, and it's always a challenge. Very often, the supplier, because they have the story because they knew the normal pattern, the cycle sometimes, they are even able to predict or to warn their customer and say, "Guys, you need to order a product because you will be short. We are not at the same level than last year." You have a conversation.

Anyway, when you have really big volumes, and when we think about the COVID volumes, it was really huge, it was really going up and down. They were announcing volumes, they were making deals for capacity management. At some point in time, when they have to stop, it's really becoming brittle. You have some exchange, but it's, anyway, a very difficult topic, and it's always challenging to really be able to have a good level of forecast and forecast accuracy. That's always challenging.

Leroy Rogers: Just this idea I want to get your thoughts on. We talked about the COVID dynamic. What about the idea that some of these large pharma companies that are responsible for some of these pressures, this destocking, that they've upgraded their inventory tools using AI, for example, to better manage their inventory.

Now, these companies can comfortably manage with lower inventory days on hand. This expectation to get back to the pre-COVID mentality, maybe not being the right way to think about things, maybe this type of inventory management among customers could be the new normal with those tools that I referenced. What are your thoughts on that idea?

Laurent Frechin: You have different tools when you are working on forecast, and with a tool that a lot of companies are using in this industry, which is a SAP, you have different modules where you have some algorithm, and you can try to create some modeling. You know that every company or the last supplier for primary packaging, they are doing strat planning, they are doing budgeting.

For them really to understand the volume, the projection, it's very, very important. Typically, when you try to really work on forecasting, you start to put, first, some intelligence, which is for the time being, at least for what I was experiencing, not artificial, but really human. You have really the marketing, making the analysis of the market, the pharma company pipeline.

Then after, we were really looking on the pipeline opportunity of the company, what was the level of participation of a supplier into the pharma pipeline to really see what would be the win rate and see what we can expect. I think this, you can really do that, but really understand, for example, when you have a new drug which would be launched or which is in commercial Phase 3, will really come onto the market and how successful will be the drug? This is very difficult because even the pharma company could have some surprise. I think we see that with Novo, what really incredible, great results with the Ozempic and the and the Wegovy. I think they have been also surprised by the success of the product.

You have, always, things that you cannot really keep under control. So far, all the MRP systems would try really to give some patterns for ordering or building inventories. So far, the pharma supply chain is, anyway - I don't know which one I could use, because if I say really not robust, I think it would be probably too strong.

You know that what the COVID has done, it has really pushed the pharma company to rethink about their operation strategy. In the past operations, it was more a cost and something that they were always trading to outsource production or to disinvest sales, manufacturing, and really try to have working with the big contract manufacturer, contract fillers.

Now, I think the pharma industry realized that it's important to better master the supply chain. Because one of the key challenge during the COVID was not only getting the packaging material, but it was all about having the filling capacity. Really for the filling finish, which is really filling the drugs into the vial or the syringe or the cartridge.

You see now the big pharma rethinking their operations strategy and trying to really view that in a more strategic way. When you have a supply chain, where you have a contract manufacturer in between, having some algorithm, I don't think that there is a tool you can, today, add to the company to do that.

Maybe it would be the trend for the future, but what is very important to always keep in mind that these key business requirements: security of supply, quality and compliance, and responsiveness. That's really what the pharma company look first. I think, to me, they will not also go too far into reducing their inventory because product shortage is really something that they do not want to see. They do not want really to be on the front page of a newspaper because one of the drug is not available anymore. We have seen that there are more and more drug shortages. That's my view on that.

Leroy Rogers: West Pharmaceutical has talked about Q4 of 2024 being when things truly start to improve. Should we have confidence that destocking won't get worse? How can we tell if we're at the bottom, given what you've described around visibility from West or lack of visibility when we think about that short term? I think you described it as the period less than 24 months.

Laurent Frechin: To me, the key is that the horizon of the pharma industry and the manufacturing, a quarter is nothing. It takes time to develop a drug, it takes time to produce components. A quarter, the normal pace of the manufacturing in the pharma industry, it's more half a year, one year, two years, three years. The quarter, it's not really relevant or meaningful to them when we think about the operation and production.

Because it's really an industry today where you do not have really, also, too much flexibility, because it's a highly-regulated industry, quality is very, very important, so you see that everything is really moving slowly.

I don't know exactly when they will go back to a normal pattern to what I have experienced, what I think, what I feel, but it's only myself speaking. I would say mid-2025, we should be back really on something which would be more normal. What is really true and key is that in this business, and if you really forget about all the COVID phenomena, the fundamentals of this business is very strong because the pharma market is a growing market.

The injectable, it's really 40% of the total activity on the pharma market. That's really where you have the most development happening. The growth is really probably closer to the low double-digit growth figures than anything else.

You have the niche of the pharma market, you have the niche of the injectable, and then you have the niche of the biological, and really, the biological, it's really where that's really the sweet spot of the West product. When you see what is really driving the growth, it's really the increase of chronic disease. I'm talking about cancer, immunology, I'm talking about diabetes.

Really, that's what really drives or what is driving the growth for the future. The COVID was just a single event, there would be probably other pandemia, but I would say the key fundamentals, the key growth driver, they are still there. After that, we will come back to normal in last quarter of 2024 or second quarter of 2025. I cannot tell you that very precisely, but to me, yes, we will go back to normal.

As I said, in this business, the fundamentals are really good and strong. I think the rubber manufacturer is probably in a better shape compared to the glass manufacturer the glass manufacturer, it's high quality product, it's for pharma, but the switching costs are much lower than they are in the rubber business. You have more competition, so you can have more swing into the market share.

While for the rubber, because of this entry, which are barrier entries, which are very high, the market shares are really more stable. You have not too much attrition, no, really, swing into the market share. As long as the pharma, the primary packaging suppliers continue to invest, they can keep their market share. The key is really locking the customer pipeline. That's really the heart of the business. That's really where you can make the difference to competition.

Leroy Rogers: We appreciate all your thoughts this morning. Appreciate you taking some time and really laying out for us how to think about this destocking trend.

Laurent Frechin: Thank you very much.