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West Pharmaceutical Services, Inc. (WST)

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CORPORATE PARTICIPANTS

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

OTHER PARTICIPANTS

David Windley
Analyst, Jefferies LLC

MANAGEMENT DISCUSSION SECTION

David Windley
Analyst, Jefferies LLC

Everybody, good afternoon. Appreciate your attendance and interest here for Jefferies 2024 London Healthcare Conference. I am Dave Windley with Jefferies at equity research based in the States, running our Nashville, Tennessee office. I cover CROs. I've been with the firm for now 24 years. I've covered CROs for that period of time; and also the contract manufacturing, supply chain, and of biopharma companies as well.

So, very pleased to have with us West Pharmaceutical Services representatives: company's CFO, Bernard Birkett; and the company's recently joined IR, Head of IR, John Sweeney.

And before I get started, I'm going to throw a little shout-out to Eric Green who couldn't be here because he's supporting his family, his daughter. So, shout-out to WashU Bears Soccer, Suzie Green. Hope you win. Go, Bears.

So, in all seriousness – I had a kid that went to WashU, too. So, in all seriousness, really pleased to have you here. Thank you very much for your time.

QUESTION AND ANSWER SECTION

David Windley
Analyst, Jefferies LLC

Q

Want to get started on kind of high-level, long-range plan thought processes. So, as we think about the building blocks of your growth, your top line growth strategy or targets, think about pricing, volume mix, and the price component of that historically has been more like 1% to 2%; volume, 2% to 3%; and maybe mix, 4%. It sounds like in recent conversations, you kind of think now that price and volume may have kind of switched places, that price is a little higher, volume is a little lower. Am I right about that? And what are some of the dynamics that are influencing the components of your long-range plan?

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

A

Well, first, Dave, thanks for the invite. It's great to be here. It's been a really positive conference for us so far. It's really interesting to see how this conference has grown over the last number of years. So, congratulations to Jefferies for the work you guys have been doing.

So, on our LRP, we're targeting growth of 7% to 9% over the – on an annual basis, and 100 basis points operating margin improvement. And typically, we've been seeing that over the last number of years. So, it's really broken down to, as you said, 1% to 2% price – or 1% to 2% volume, 2% to 3% price, and then the balance is mix shift.

When we look at it on a market unit perspective, really, we're seeing biologics-targeted growth, high single-digit growth, double-digit growth rates, and more Generics market unit growing at mid-single-digit, high single-digit growth. And then pharma market unit segment. Typically, we see low-to-mid single-digit growth rate within pharma. And then our contract manufacturing business, we see typically growing mid-single-digit range, and that's what we target for that space.

So, to support the 7% to 9% over the long term, we're looking at couple of major growth initiatives within our sector. Typically, we don't rely on just one aspect of growth. So, we're seeing continued strong participation rate within the Biologics market segment, where participation rate in Phase 2, Phase 3 clinicals is very high and is probably stronger than what we would have seen in the past. And we're – so we're continuing to see that traction and developing the funnel there.

We've also got the growth within the GLP-1 segment, which we support both from a proprietary elastomer perspective and also from within contract manufacturing. So, we've been layering in capacity over the last number of years to be able to support growth in both of those areas, and that's resulted in an elevated level of capital deployment. But again, it's focused on growth.

And then, the other element that we're seeing is, on the regulatory landscape, we're seeing changes, particularly here in Europe, where we're seeing the continued development around Annex 1 and on primary packaging, the focus around quality, and levels of particulate that are expected now from providers of various molecules.

So, when we look at that, we see that as not a volume driver, but really a conversion driver. So, we're converting from standard product to HVP, particularly focusing around pharma washing services, Envision, autoclave sterilization. And again, that's where we've made a lot of investments over the last number of years.

And then now, we're also assessing how does operators who are operating outside of the EU will want to export into the EU, what sort of markets that will develop for us around Annex 1, and how it will support that growth. So, the LRP, in our view, is pretty robust, a lot of different elements driving that growth which supports it. And then, that in itself leads to the 100 basis points operating margin expansion, primarily coming from that mix shift in HVP and taking us up the curve.

David Windley
Analyst, Jefferies LLC

Q

So, on the price component of your LRP for a number of years before COVID, the typical taking was, I think, typically had a 1 handle, 1% to 2%, somewhere in there. My memory is closer to 1%. And then you had a couple of years where you were pushing through COVID-related inflation, and so it was higher. Probably everybody would have understood that wasn't sustainable. But you are landing now around 2% to 3%, maybe closer to 3%. How durable do you think that price taking is, say, over the horizon? How are you thinking about that?

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

A

Yeah. So, what we've done over the last number of years is really went back and examined our pricing methodology and where we were actually taking price, and also examining where we were actually adding value and bringing value to customers. So, when we examined that, we found that in certain areas, there were greater opportunities for value capture. And we have focused on those over the last number of years.

As you said, we've seen a steady incremental improvement in pricing as we've moved through COVID and beyond. For a couple of years, we were getting north of 4%, but some of that was inflationary pressures that we were experiencing driving that acceleration in pricing.

So, when we look at us and we divided our business, to be – looking at our CM segment, which, really, we don't see a lot of price take there, we have our standard products. When we look at it again, there isn't as much opportunity to take price. That's a more competitive space.

And then when we look at HVP, we have to break that down between contracted and non-contracted business. So, again, different pricing strategies within each of those segments. So, that helps us to land at the overall 2% to 3% price take on an annual basis, and we believe we can support that over the long term.

David Windley
Analyst, Jefferies LLC

Q

Okay. And then flipping to the other piece, the volume, it does seem like biologic pipeline activity is good. GLP-1s are certainly headed toward being a very large category. What in the landscape would shade that, I guess, and cause you to dial back to the volume component of the LRP? Because I think that's come in about 1%.

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

A

Yeah. Typically, what we're seeing around more legacy-type products sold, product that we would typically categorize within our pharma market unit, that's where we're seeing lower levels of growth. It's about 1% within that space. And then within the Biologics space, we're actually seeing higher levels of growth from a volume perspective.

But, again, part of our growth is volume-based, and then part of our growth is mix shift. In the mix shift, in the past, some of it was based on converting new molecules to HVP as soon as they were launched. But what we're actually seeing now is that, again, as I mentioned in Annex 1, we have the opportunity of converting existing volume from standard product to HVP. So, it's a mix for us of obviously the volume, but the mix shift is also very important.

David Windley
Analyst, Jefferies LLC

Q

And I assume that within mix, maybe jumping ahead here, but as you highlighted, the evolving drivers of mix, I kind of expected you to go to before would have been a mix up to, say, a Westar-level product. And today, I think it's mixing up to FluroTec and NovaPure, which has – carries a higher ASP and a higher margin, so has more – has a more powerful effect...

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

A

Yeah.

David Windley
Analyst, Jefferies LLC

Q

...on mix.

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

A

And that's what we're seeing, particularly within the Biologics space. Customers are tending to go to that higher end, looking at NovaPure stoppers and plungers. Obviously within Generics, we're also seeing a shift to FluroTec. And a lot of this is driven by the complexity of the molecules that are being brought to market, the higher levels of quality that are required and lower levels of particulate. So, there are a number of drivers within that HPV continuum.

And as I said, I think that now one of the opportunities, which wasn't as prevalent in the past, is really around being able to convert existing business from standard to HVP and drive the acceleration on that curve.

David Windley
Analyst, Jefferies LLC

Q

Got it. So, let's move then to some of the current environmental issues, a.k.a., destocking. So, I think the company, as destocking kind of began to impact the business, it took hold in pharma first, followed by biologics, followed by generic. And your thought was that you would see kind of those same market units come out of destocking in the same order. Talk about what you have seen and what your current views are about how this is going to progress.

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

A

Yes. I think we got to step back and look at why are we experiencing this destocking. From a sector perspective, it's not specifically related to just West. We saw huge changes happen during COVID. And as an industry, we were trying to respond to COVID in a relatively short period of time. The demand accelerated in a number of different areas. Our lead times got pushed out. We were responding to Project Warp Speed, where we had to prioritize getting product out there for vaccines. But for us at the time, it was also making sure we didn't stock out any customers and to make sure that they could get the supply that they were requesting from us.

And as soon as COVID probably peaked, it fell off just as quick. And then, we've got into this destocking cycle, which probably has taken everybody by surprise. And then, trying to fully understand how much inventory is in the pipeline. It's not just how much raw components are sitting in a warehouse. It's how much is in the warehouse, how much is in WIP, how much product is sitting at distributors. So, there is a number of different permutations as to how much inventory was in the system.

Then we also went into a period where this working capital management. The pressures to reduce inventory in many companies accelerated over that period of time. Then we went into high interest rate environment, which further impact us, the working capital management practices of a number of companies. And we're starting to see all of that play out.

And for us, we did see the destocking within standard products was the first area that we've seen it, apart from destocking within COVID. And that's why now we're seeing the pharma market unit come out of that destocking. And in Q3, we saw a level of growth. And now, we would expect that to continue as we move forward.

On the Biologics segment, we have seen some level of destocking as we've even gone through 2024. We saw it again in Q3. We expect to see continued destocking within Biologics here in Q4, but moderating slightly. And then in Generics, it's still – we're seeing destocking continue through the end of 2024 and possibly into 2025 as that inventory flushes itself out.

Plus, companies are reviewing their inventory holding policies. They're also assessing our ability now to deliver based on our much shorter lead times than we had over the last number of years. So, we're back down to pre-COVID kind of average lead times of 8 to 12 weeks, where during 2020-2021, in some instances, we were up at over 50 weeks.

So, that in itself is also kind of helping inform how customers are ordering. Their order pattern is getting back to more pre-COVID type, where it's smaller orders, but greater number of orders. So, they're able to manage their inventory. For us, that's also better, because it allows us to level-load our plants, so we don't get whipsawed [ph] of these (00:14:29) to various peaks and troughs in customer order requirements.

So, my sense is, over time it'll put us in a much more efficient space. We have the capacity in place to respond to the growth drivers that I've spoken about and also to accommodate demand normalization as we move forward.

David Windley
Analyst, Jefferies LLC

Q

Got it. In the Generics, so the Generics are kind of progressing through this process with the most lag or the latest are slowest. Is there any effect of some Generics removing products from the market, like fewer competitors within generic categories, and therefore less need for containers? Is that a factor at all?

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

A

That's not something that has come up for us. We haven't seen that as a reason why we would be seeing destocking within Generics. I think it's more essentially customers had ramped up their inventory that they were holding. And now, they're obviously unwinding that. And a big part of it for them is probably managing the working capital, given the space that they're operating in. And as I said, with interest rates moving, it's a pretty cost competitive environment. So, a lot of these factors are now playing into how they're destocking.

David Windley
Analyst, Jefferies LLC

Q

Got it. And then, kind of exiting this destocking process and thinking more broadly about long-term management and governance of the business, are there this lead times lengthening, customer over orders, then you fix the lead times, then we realize, oh, well, they had way too much inventory? This kind of gotcha situation has played out multiple times in the past. What intelligence systems can you put in place, or do you want to put in place coming out the backside of this to help to mitigate these types of things happening in the future?

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

A

Yeah. My sense of that is that when demand is more – is normalized, obviously it's a lot easier for us to predict. Our customers' forecasts are much more reliable. When they need us, typically only varies by a quarter or two, so they move stuff around. So, pre-COVID, we had a pretty good handle on what the order patterns were, what the demand was, and then how we could fulfill that. And we were managing our lead times pretty effectively. We were seeing considerable improvements, even as we went from 2018 to 2019.

My take is that the COVID was really unprecedented. It was a real outlier. How often would that happen? I don't really see that being a normal way for us to do business. So, we responded the best we could. We gave customers what they needed at – when they needed it, and we didn't cause any, like, shortages or outages in the market. So, that's the first thing.

I think the way we have tried to accommodate now is by looking at our capacity. Also looking at where the pinch points were during COVID, where did we get constrained, and layering in levels of capacity where we were able to – we're able to flex it in a more efficient way moving forward. So, hopefully responding to that, if there are spikes in demand without lead times extending. That in itself helps reduce the stocking phenomenon where customers have, like, guarantee and security about supply.

We're also looking at how we manage our network more effectively, having customers dual-sourced within our network rather than single-source from a site where we can get constrained in one site and be unconstrained in another and not being able to use that capacity. So, we're working with customers to have them validated across a number of sites. And that's part of the strategy around HVP and the network optimization of the five sites that we have.

So, from our perspective, they're some of the initiatives that we're putting in place to make sure that we're able to manage lead times more effectively within somewhat normal business circumstances as we move forward.

Our relationship with our customers and understanding their forecasts, I think it's – this whole experience has forced us and them to relook at the information that's been shared and where it's coming from on our full understanding of the supply chain. And so we continuously work with them on improving that and keep that contact, developing it and understanding their systems and ours. And then, how does AI play into this is something that we're also trying to figure out.

David Windley
Analyst, Jefferies LLC

Q

Yeah. I want to move on to high-value products. On the elastomer side of things, margins, particularly gross margins, have been impacted by this destocking by the fact that you have capacity in place to service order volumes that are higher than we're currently seeing.

The factors, though, influencing margins seem to me to be both lower utilization of capacity, and therefore absorption of the fixed cost structure. And then, also a suboptimal mix of products. because your Biologics unit is not kind of back to normal, and it's a high user of high-value products.

Can you help us to disentangle kind of how much of each of those things is contributing? Like, if volume comes back but it's standard product, how much margin lift do we get? And do we need high-value products to really drive the margin?

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

Yeah. Typically – so, you're exactly right, it is when you have destocking, particularly within the Biologics market unit and its high-value product, you are going to see that outsized impact on gross margin. And where we saw the opposite effect of that is when we went through COVID and we were supporting the COVID vaccines with high-value product stoppers. We saw this outsized margin expansion way beyond 100 basis points. So that in itself shows us the power of these HVP growth and conversion. And then, you couple that with having layered in capacity and underutilization in particularly HVP sites, you are going to get that margin compression.

When we look at it, it was about 60/40 split between volume mix and efficiencies. So, it's really just between the two of them, I think, 300 basis points on the volume mix, if I can remember, and then 200-and-something basis points on overall efficiencies and utilization.

David Windley
Analyst, Jefferies LLC
Q

Okay. Okay.

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

But I have to check those numbers exactly. But ballpark, that's pretty close.

David Windley
Analyst, Jefferies LLC
Q

Okay.

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

But the question then, does the high-value products get replaced with standard product growth? That's not what we're seeing, and we will see, because even if you think about it and think of the way the market is developing and the regulatory environment is developing, that tells us that the growth is really in HVP. It's not in standard-type products, where you have to supply into Annex 1. We're supplying into GLP-1, and we're supplying into a growth within a Biologics segment, where the volumes are growing at a much faster rate than our standard product volumes will be growing.

So, the market tells us that. And that demand – when that demand normalizes and the market and the mix shift normalizes, we will be getting back to, like, our kind of 2023 operating margin levels, and then growing 100 basis points per year off that, just based on our long-term construct.

David Windley
Analyst, Jefferies LLC

Q

So, just to clarify on that, so you do expect, as you recover volume and get back to normal order patterns, that you get kind of a super-powered recovery in the margin structure back to normal, and then resume LRP-type trajectory from there.

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

A

Yeah. Yes, exactly. And when demand – and that's when demand and mix normalizes, that margin will rebound, because the other fundamentals of our business haven't changed. Our OpEx line is still pretty normalized as a percentage of sales. That hasn't expanded. The only thing that's happened within our manufacturing operating units is that we've added in capacity. So, there hasn't been any fundamental cost structural changes within our business. It's really this mix normalizing will drive that margin improvement.

David Windley
Analyst, Jefferies LLC

Q

Yeah. So, we've got a bunch of things I want to try to get through, but we're not going to have enough time. So, I believe that management has been at other conferences recently talking on – you mentioned Annex 1 – talking about 100 to 200 programs that the company is working on that would be conversions of products for Annex 1. Is that correct?

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

A

Yeah. So, there's 200 projects ongoing at the moment with a number of different customers to look at converting some of that product to HVP based on Annex 1, and we have to see them convert. And also, within that timeframe, it could take 12 to 24 months.

So, the good thing is, the formulas aren't changing for the products that we're working on. It's really – it's changing the processes. So, from a refiling perspective for customers, it's pretty minimal on what they have to do. So, that speeds up the transition to HVP products for Annex 1 support.

David Windley
Analyst, Jefferies LLC

Q

Okay. The – to my ear, the first time I had ever heard the brand NOVACHOICE was the third quarter call. That was described as being the kind of applicable product for GLP-1s, a NovaPure-like product, but without the coding. I would suspect that those clients would have had to spec into that years ago. Where did NOVACHOICE come from?

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

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NOVACHOICE is really an unlaminated version of NovaPure. So, it's unlaminated. And for GLP-1, it's a peptide, and so it doesn't need a laminated product. Like, it's not -from our perspective, when we're looking at Biologics,

Biologics will typically have a coated product. But GLP-1s, it's a peptide. So, it has – from our perspective, when we called this out on a number of occasions, and I've talked to people about this, saying it's a peptide. It's NOVACHOICE. It's a non-laminated product. It's still a HVP. It sells within the range, let's say, $0.15 to $0.30 margin, 60%-plus. So, the HVP type margin profile. But GLP-1s do not use NovaPure.

David Windley
Analyst, Jefferies LLC

Q

Okay.

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

A

At the moment now, if there are more complex ones developed over time, maybe they'll transition to them.

David Windley
Analyst, Jefferies LLC

Q

The number – the time is flashing at me in the back, but I'm going to ask one more, and that is around the high-value devices. Those devices in the third quarter were described as, like, 20% margin, which is not particularly a high-value margin profile. Does that include the $19 million of incentive fees to get to that margin? Or would that be upside to those margins?

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

A

With that in there, they – it'd be like between 20% and 30% margin. The – where we're going to see that incentive, again, repeat itself and – not the exact same figure, but repeat here in Q4. And what we – we know with the SmartDose device, it can get to HVP margins over time. It's just scaling the product to the right level of the volumes. Plus, at the moment, it's being built on manual lines. And with a fully automated line, that will be onboarding as we move through 2025 and into production late 2025, early 2026.

David Windley
Analyst, Jefferies LLC

Q

And we're getting to HVP like margins would be roughly 50%?

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

A

Yeah. We will be targeting like that 50% range.

David Windley
Analyst, Jefferies LLC

Okay. All right. I'll leave it at that. Thanks for the extra time in the back. Thanks for everybody's attention, and we'll call it there. Enjoy the rest of the conference. Thank you.

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

Thank you.