Embecta Corp.
Q1 FY 23 Earnings Call Script
February 14th, 2023

Operator:

Please standby. Welcome, ladies and gentlemen, to the fiscal first quarter 2023 embecta Earnings Conference Call.

At this time, all participants have been placed in a listen-only mode.

Please note that this conference call is being recorded and that the recording will be available on the Company’s website for replay following the completion of this call.

I would now like to hand the conference call over to your host today, Mr. Pravesh Khandelwal, Vice President of Investor Relations. Please go ahead.

Pravesh Khandelwal:

Thank you, operator.

Good morning, everyone and welcome to embecta’s fiscal first quarter 2023 earnings conference call.

The press release and slides to accompany today’s call, and webcast replay details, are available on the Investor Relations section of the Company’s website at www.embecta.com.

With me today are Dev Kurdikar, embecta's Chief Executive Officer; and Jake Elguicze, our Chief Financial Officer.

Before we begin, I'd like to remind you that some of the matters discussed in the conference call will contain forward-looking statements regarding future events as outlined in our slides. We wish to caution you that such statements are, in fact, forward-looking in nature and are subject to risks and uncertainties and actual events or results may differ materially. The factors that could cause actual results or events to differ materially include but are not limited to, factors referenced in our press release today as well as our filings with the SEC, which can be accessed on our website. In addition, we will discuss certain non-GAAP financial measures on this call, which should be considered a supplement to, and not a substitute for financial measures prepared in accordance with GAAP. A reconciliation of these non-GAAP measures to the comparable GAAP measures is included in our press release and conference call presentation.

Starting on Slide 3, our agenda for today's call is as follows:

- Dev will begin by providing an overview of embecta; our strategic priorities for 2023; and some remarks on the overall performance of our business during the first quarter;
- Jake will then provide a more in-depth review of Q1 financial results, as well as our updated financial guidance for the year;
- We will then open the call for questions.

With that said, I would now like to turn the call over to our CEO, Dev Kurdikar.

Good morning everyone, and thank you for joining us today.

A life with diabetes doesn't have to come with limitations, and at embecta, our mission is to develop and provide solutions that make life better for people living with diabetes.

At every stage of the diabetes care journey, we are there by a person's side because we believe that no one should have to live with diabetes alone.

We are driven by a sense of urgency to advance what's next in diabetes, and for nearly 100 years, we've been accelerating the journey to better diabetes care.

Whether you're newly diagnosed, or transitioning to a new line of therapy, we are working to make a person's everyday experience as comfortable and convenient as possible, while also advancing a new generation of solutions.

During 2023, our strategic priorities are centered around three pillars, as shown on slide 5.

- First, we will focus on continuing to strengthen our base business, while maintaining our global leadership position in the category of insulin injection devices. Examples of this are our inclusion on the Express Scripts National Preferred Formulary, as well as recent pen needle and insulin syringe contract wins from the US Department of Veterans Affairs.

- Second, as a recently spun-off, new public company, 2023 is a critical year for embecta to stand-up our own systems, processes, and procedures so that we can achieve a timely separation from BD. During the first quarter, we continued to make progress in this area, as evidenced by the exit of several transition service agreements.

- And finally, we also have our eye on the future, and we intend to continue investing in R&D, most notably around our patch pump that is being developed for the Type 2 market. In addition, we are continuing to evaluate suitable M&A and partnership opportunities to add market appropriate products to our portfolio.

We remain energized about our long-term prospects, as we work towards creating the preeminent diabetes focused company in the world.

Turning to our performance during the first quarter of 2023 on slide 6.

During Q1, we delivered strong commercial performance, despite a challenging macro-operating environment, as we generated revenues of $275.7 million. This represented a decline of 4.7% on an as-reported basis, but an increase of 0.7% on a constant currency basis.

Our Q1 revenue was better than we initially expected, as we exceeded our constant currency revenue expectations for both the U.S. and International markets.

Foreign currency, while a headwind during the quarter, was modestly better than we originally thought.

And while Jake will go through this in more detail in a few minutes, like revenue, our adjusted gross, adjusted operating, and adjusted EBITDA margins for the first quarter also exceeded our expectations, as we generated adjusted gross margin of 68.5%, adjusted operating margin of 36.9%, and adjusted EBITDA margin of 40%.

This solid operating performance translated into adjusted diluted earnings per share during the first quarter of 2023 of 96 cents.

In addition to getting off on the right track from a financial perspective, during the first quarter we also took steps to strengthen our base business, including holding over 50 scientific and educational events, which reached over 2,000 healthcare professionals.

I'm also pleased to say that effective January 1st, embecta's pen needles and insulin syringes are the exclusive preferred products on the Express Scripts National Preferred Formulary. By working together to achieve widespread formulary access, embecta and its partners continue to reduce barriers for patients and prescribers in the markets it serves.

We also recently won national contracts for both pen needles and insulin syringes from the US Department of Veterans Affairs for a 5-year term. These awards not only demonstrate our commitment to the singular focus of improving the lives of people living with diabetes, but also ensure our nation's Veterans have access to the highest quality products.

Moving to separation and stand-up activities, we continue to make progress on that front as well, as we exited several transition service agreements, and continue to build up our own internal organization, systems, and processes.

From an invest-for-growth perspective, our commercial teams began to execute on the strategic partnerships we announced a few months ago; and we continued to progress the development of our insulin patch pump.

Finally, based on our strong first quarter results, we are raising our financial guidance ranges for as-reported and constant currency revenues; adjusted gross, operating, and EBITDA margins; as well as adjusted diluted earnings per share.

Next, let's review our first quarter revenue performance in a bit more detail on slide 7.

During Q1, U.S. revenues totaled $149.3 million which represented a decrease of 1.1% on a constant currency basis.

The slight year-over-year decline in the U.S. was primarily due to unfavorable volume dynamics, the majority of which was offset by the favorable timing of certain distributor purchases that occurred late in the quarter; as well as the contract manufacturing and sale of certain non-diabetes product to BD.

As we move forward, we anticipate this timing benefit associated with distributor purchasing, which is not uncommon in our business and which totaled approximately $6 million in Q1, to largely reverse itself during the second quarter.

Turning to our performance outside of the U.S.

During Q1, International revenues totaled $126.4 million, or an increase of 2.6% on a constant currency basis.

The year-over-year growth within our International business was primarily due to favorable pricing, as well as favorable volumes, which were augmented by a competitor product supply shortage in certain regions.

With that, let me turn the call over to Jake to discuss our Q1 financial results in a bit more detail, as well as provide our updated fiscal 2023 financial guidance and underlying assumptions.

Thank you, Dev, and good morning, everyone.

Before I discuss the financial results for the three-month period ending December 31st, I would like to remind the investment community that embecta was spun-off from BD on April 1st, 2022, and that the financial results during the pre-spin periods were based on carve-out accounting principles, and do not reflect what embecta's financial results would have been had embecta operated as a standalone public company.

Therefore, the financial results for the three-month periods ending December 31, 2022, and December 31, 2021, are not meaningfully comparable.

Turning to embecta's financial performance for the first quarter.

Given the discussion that has already occurred regarding revenue, I will start at the gross profit line.

GAAP gross profit and margin for the first quarter of fiscal 2023 totaled $188.8 million and 68.5%, respectively. This compares to $203.9 million and 70.5% in the prior year period.

The year over year decline in GAAP gross profit and margin was expected, and primarily driven by the negative impact of inflation; the impact of low-margin contract manufacturing revenue that was not in the prior year period; and incremental stand-up and separation costs, including the markup on the purchase of cannula from BD.

While on an adjusted basis, gross margin for the first quarter of 2023 was also 68.5%.

The adjusted gross margin performance during the first quarter was better than we initially expected, primarily due to the mix of additional revenue that we generated during the quarter.

Finally concerning gross margin, during the first quarter of 2023, both our GAAP and adjusted gross margins benefited from the revaluation of our inventory to our new 2023 standard costs which occurs once a year; as well as from positive absorption, as we manufactured additional product in advance of our planned temporary suspension of our facility in Suzhou, China later this year. While these items were taken into consideration when we provided our initial guidance, I point them out because as we move forward during the remainder of 2023, we do not anticipate the same level of positive impact to our gross margins, and as such, we currently expect our adjusted gross margins to trend downward in succeeding quarters.

Turning to operating income and margin, during the first quarter GAAP operating income and margin was $88.8 million and 32.2% respectively. This compared to operating income and margin of $116.6 million and 40.3% respectively in the prior year period.

The decline in year-over-year GAAP operating income and margin is primarily due to the GAAP gross profit and margin drivers that I just mentioned, as well as an increase in operating expenses associated with separating embecta and becoming a stand-alone publicly traded company.

On an adjusted basis, during the first quarter of 2023, operating income and margin was $101.6 million and 36.9%, respectively.

This adjusted operating income and margin performance was significantly better than we initially expected, in part due to the revenue timing benefit that positively impacted our adjusted gross margin, as well as lower operating expenses in the quarter versus expectations, which we believe is also largely timing related. This operating expense timing benefit was primarily due to lower separation and stand-up costs; the phasing of hiring; and certain project spending.

As we move forward during the remainder of fiscal 2023, we anticipate that this spending will occur, and as such, we currently expect our adjusted operating margins to trend downward in succeeding quarters.

Turning to the bottom line.

GAAP net income and diluted earnings per share was $35.2 million and $0.61 per share during the first quarter of fiscal 2023. This compared to $98.8 million or $1.73 in the prior year period.

As I mentioned at the outset, because our financials for pre-spin periods was done on a carve-out accounting basis, the comparisons of pre-spin to post-spin periods are not meaningfully comparable. One example of this is interest expense, which burdened our P&L in the current year, but was zero in the prior year period.

While on an adjusted basis, net income and earnings per share was $55.4 million and $0.96 per share during the first quarter of fiscal 2023.

Lastly from a P&L perspective, for the first quarter of 2023 our adjusted EBITDA and margin totaled approximately $110.2 million and 40.0%. This compares to $138.3 million and 47.8% in the prior year period.

Like our adjusted operating margin, due to the revenue and gross margin overachievement in the quarter, coupled with the timing benefit from lower operating expense spending, our adjusted EBITDA margin during the first quarter also significantly exceeded our original expectations.

Finally, with respect to our balance sheet and financial condition at quarter-end.

As of December 31st, 2022, we held approximately $385 million in cash and cash equivalents, and approximately $1.64 billion in debt, which taken together with our last-twelve months adjusted EBITDA, resulted in a net leverage ratio of approximately 2.9x.

That completes my prepared remarks as it relates to embecta's financial results for the first quarter of fiscal 2023.

Next, I would like to discuss embecta's updated 2023 financial guidance and certain underlying assumptions.

Beginning with revenue on Slide 9.

Given our strong performance in the first quarter, we have increased our guidance by 50 basis points on both the low and high-ends of our constant currency revenue guidance range, as we are now calling for a decline of 1.5% on the low-end, to 50 basis points of growth on the upper-end.

The low-end of our constant currency revenue range continues to assume that most of the potential decline will result from reduced contract manufacturing revenue of non-diabetes care products that are sold to BD, with the remainder coming from slight volume pressure within developed markets, as well as periods of uncertainty in emerging markets due to the potential for COVID-19 spikes like those we saw impact our business in China during the first quarter of fiscal 2023.

The high-end of our constant currency revenue range continues to assume a slightly smaller year-over-year headwind associated with contract manufacturing revenue, flattish product volumes, and the ability for us to modestly raise prices on our product offerings.

And while we continue to make progress in this area, our updated constant currency revenue guidance range continues to assume an immaterial amount of revenue associated with our recently announced partnership agreements.

Turning to our thoughts on F/X.

Since we provided our initial guidance for 2023, foreign currency exchange rates have moved in a positive direction, and as such, our updated guidance now calls for a foreign currency headwind of approximately 2.5% during 2023. This compares to our original assumption which called for a headwind of approximately 5%.

Our updated F/X assumptions were based on foreign exchange rates that were in existence in the early-February timeframe.

On a combined basis, we are raising our full-year as-reported revenue guidance from a range which called for a decline of between five and seven percent, to a new range which calls for a decline of between two and four percent. In dollar terms this equates to a revenue range of between one billion and eighty-four million and one billion one hundred seven million.

Lastly concerning revenue, during fiscal year 2022, we generated approximately 50% of our as-reported revenue dollars during the first half of the year. Consistent with our initial guidance that we had provided in December, we continue to anticipate that we will generate a slightly lower percentage of our annual revenue during the first half of 2023.

Moving to margins.

Due to the performance that we achieved in the first quarter, coupled with foreign exchange favorability as compared to the initial guidance, we are raising the low and high ends of our adjusted gross, adjusted operating, and adjusted EBITDA margins by 150 basis points each, as we now anticipate that our adjusted gross margin will be approximately 63.5% for fiscal 2023, up from our original guidance of approximately 62%; our adjusted operating margin is now expected to be approximately 26.5%, up from our original guidance of approximately 25%; while our adjusted EBITDA margin is now projected to be approximately 31.5% for full year 2023, up from our original guidance of approximately 30%. Regarding the 150-basis point improvement in margins, we estimate that approximately half is due to an improvement in F/X, while half is due to an improvement in base business operations.

These new guidance ranges continue to call for adjusted operating expenses to be approximately 37% for the entirety of 2023, comprised of R&D expense as a percentage of revenue reaching 7%, and SG&A of approximately 30%. This assumes that the timing-related operating expense favorability we saw in Q1 reverses itself as we move throughout the remainder of the year.

Continuing down the P&L, we currently expect that our net interest expense will be approximately $115 million during 2023, or closer to the low-end of our previously provided range.

Our assumptions regarding our non-GAAP tax rate and weighted average shares remain unchanged from our original assumptions of approximately 25% and 57.7 million shares, respectively.

At the bottom line this translates into our new full year 2023 adjusted diluted earnings per share range of between $2.20 and $2.35, which is an increase from our previous range of between $1.75 and $2.00; or a raise of approximately $0.40 at the mid-point. Like the increase in our margin guidance, we estimate that approximately half of the increase at the mid-point of our guidance range is attributed to F/X, while half is due to an improvement in our base business.

In closing, during the first quarter, embecta made good progress in each of our three major strategic priorities, including strengthening our base business; separating and standing ourselves up as an independent entity; and investing in growth.

We generated solid financial performance during Q1, and we are pleased to be able to raise several of our financial metrics after only one quarter.

As we look ahead, we still have some important separation activities in front of us, including the implementation of our ERP system, as well as managing through the anticipated temporary suspension of manufacturing operations associated with the regulatory approvals and transitions, including for inspections, at our facility in China. And our teams remain highly focused on these and other separation related activities.

That completes my prepared remarks, and at this time, I would like to turn the call over to the Operator for questions.