Embecta Corp.
Q3 FY 23 Earnings Call Script
Aug 8th, 2023

Please standby. Welcome, ladies and gentlemen, to the fiscal third 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.

Thank you, operator.

Good morning, everyone and welcome to embecta's fiscal third 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 President and Chief Executive Officer; and Jake Elguicze, our Chief Financial Officer.

Before we begin, I would 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.

Our agenda for today's call is as follows:

- Dev will begin by providing an update on the progress we've made on our strategic priorities for 2023; as well as some remarks on the overall performance of our business during the third quarter and year-to-date period;
- Jake will then provide a more in-depth review of our Q3 financial results, as well as our updated financial guidance for the year;
- And we will then open up the call for questions.

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

Dev….

Good day everyone and thank you for taking the time to join us this morning.

This time last year we announced the results of our very first quarter as an independent public company, and I am pleased to say that we have made tremendous progress standing up our organization since then. I am especially energized by the continued execution of our global team across all elements of our business and strategic priorities, because we are not just here to build a new company, but to also continue our mission of developing and providing solutions that make life better for people living with diabetes. At embecta, we keep their needs front and center, because we want everyone to be able to enjoy a life unlimited by diabetes.

As we turn to the next slide, you will see the strategic priorities that will help us advance toward this vision.

First, we remain focused on strengthening our base business, while maintaining our global leadership position in the category of insulin injection devices.

Second, we continue to make progress in stand-up and separation activities to ensure success as an independent company.

And finally, we remain focused on accelerating our constant currency revenues, as we continue investing in growth, most notably around our insulin patch pump program that is being developed for the Type 2 market, as well as seeking M&A and additional partnership opportunities.

We are moving with purpose and urgency in each of these three areas.

During the third quarter, our team's disciplined execution was the key to delivering solid financial results that, once again, exceeded our expectations, while also advancing these strategic priorities.

In terms of strengthening our base business, we recently initiated a pilot launch of a finer gauge pen needle with our Nano PRO hub design in Japan. Today, with more than 1 out of 3 people injecting with a 34G pen needle in Japan, we are proud to provide another option for them to choose from. We look forward to getting feedback from our customers regarding this new product over the next several months.

We also made progress in our separation efforts, as demonstrated by the exit of several transition service agreements, as we continue to build up our internal organization, systems, and processes. This includes the implementation of our own global HR Information System, the rollout of a new customer relationship management system, and the setting up of our global IT network.

Importantly, we also began the demerger process for our manufacturing facility in Suzhou, China. As we have noted before, this was a deferred entity at the time of our separation from BD. The transfer of the Suzhou plant to embecta follows a specific process involving several steps including obtaining licenses, registering products, and undergoing inspections. The first step is obtaining a business license and we have done so. Now, as required by local regulations and as we have long planned, we have temporarily suspended operations at our manufacturing facility as we go through the rest of the steps. During this temporary suspension period, we have begun implementing our new Enterprise Resource Planning system at the facility. Also, as a reminder, we have built up enough inventory to ensure continuity of product supply to our customers during the time that the shutdown is anticipated to last.

Finally, from an invest for growth perspective, our patch pump program continues to make good progress, including on the development effort required for the integration of Tidepool's insulin dosing algorithm. We have also initiated a small observational study in partnership with the Jaeb Center for Health Research to analyze adults with Type 2 diabetes currently using Tidepool's algorithm.

As you might recall, our Tidepool collaboration is specifically for the Type 2 closed loop patch pump. Based on the plan of the patch pump program we have previously laid out, our initial focus is on the filing of a 510(k) and obtaining FDA clearance in the US for the open-loop version. This is expected to be followed by a clinical study for our closed-loop version, with the intention to subsequently obtain FDA clearance for use of the closed-loop system in individuals with Type 2 diabetes.

Overall, even as our team has been working on critical projects to stand up embecta, exit TSAs, and drive future growth, our global team has continued to execute commercially. This has allowed our core injection business to remain stable, and, once again, raise our guidance for key financial metrics for fiscal year 2023.

Now, let's review our third quarter, and year-to-date, revenue performance in a bit more detail.

During Q3, we generated revenue of $286.1 million, which represented a decrease of 1.7% on an as-reported basis, and 0.3% on a constant currency basis. When normalizing for the impact of year-over-year changes of the non-diabetes products that we contract manufacture and sell to BD, our underlying core injection business grew approximately 0.5% on a constant currency basis.

These results exceeded our previously communicated expectations, which called for a sequential decline in our as-reported revenue dollars from Q2 to Q3. In relation to our previous expectations, from a product standpoint Q3 revenue came in stronger primarily due to the performance of our pen needle and safety products, as well as slightly more than anticipated contract manufacturing revenue during the quarter. While from a geographic perspective, Q3 revenue came in better than we previously thought in most countries, including the U.S. and China.

Regarding the U.S., during the quarter revenue totaled $153.9 million, which was a year-over-year constant currency decline of approximately $4.1 million, or 2.6%. This was driven by two things that contributed almost equally. The first being lower year-over-year contract manufacturing revenue from the sale of certain non-diabetes products to BD, which impacted the U.S. by about $2.3 million; and the second being unfavorable changes in volume, which had an impact of approximately $1.8 million. As a reminder, during the third quarter of 2022 our business in the U.S. benefited from the timing of distributor orders, and as a result, had a difficult comparison. Had it not been for this timing item that positively impacted the year-ago quarter, our results in the U.S. for our core injection products would have been up modestly. Lastly, pricing in the U.S. was flat in the quarter as compared to the year-ago period, as increases in the average selling prices of like-for-like products was offset by a rebate reserve adjustment that positively impacted the year-ago quarter and did not reoccur this quarter.

Turning to our performance outside of the U.S.

During Q3, International revenue totaled $132.2 million, which equated to year-over-year constant currency growth of approximately $3.2 million, or 2.4%. Growth internationally was primarily due to favorable pricing dynamics, as well as an increase in product volumes, which were aided by a competitor product supply shortage in certain regions.

Turning to our revenue performance for the first nine months of the year, we generated revenues of $838.9 million, which represented a decrease of 1.9% on an as-reported basis, but an increase of 1.4% on a constant currency basis. When normalizing for the impact of year-over-year changes of the non-diabetes products that we contract manufacture and sell to BD, our underlying core injection business grew approximately 0.8% on a constant currency basis.

From a regional perspective, U.S. revenues totaled $449.6 million, which was relatively flat on a constant currency basis. While International revenues totaled $389.3 million, which equated to year-over-year constant currency growth of approximately 3.2%, driven primarily by emerging markets performance.

That completes my prepared remarks, and with that, let me turn the call over to Jake to discuss our Q3 financial results in a bit more detail, as well as provide our updated fiscal 2023 financial guidance and underlying assumptions.

Jake…

Thank you, Dev, and good morning, everyone.

Before I discuss the financial results, 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 nine-month periods ending June 30, 2023, and June 30, 2022, are not meaningfully comparable.

Given the discussion that has already occurred regarding revenue, I will start my review of embecta's financial performance for the third quarter at the gross profit line.

GAAP gross profit and margin for the third quarter of fiscal 2023 totaled $189.5 million and 66.2%, respectively. This compared to $202.9 million and 69.7% in the prior year period.

The year over year decline in GAAP gross profit and margin was expected and was due to a combination of factors, which include the impact of inflation on the costs of certain raw materials, direct labor, and overhead; product and geographic mix; incremental stand-up and separation costs and F/X. This was somewhat offset by manufacturing productivity improvement programs and increases in the average selling prices of our products.

While on an adjusted basis, gross profit, and margin for the third quarter of 2023 was $189.6 million and 66.3%.

As compared to our prior outlook, our adjusted gross margin during the third quarter of 2023 was better than we previously expected, and this was due to higher than anticipated revenue; favorable geographic and product mix; and our ability to manage the costs incurred to stand-up the organization.

Turning to GAAP operating income and margin, during the third quarter they were $51.3 million and 17.9%, respectively. This compared to operating income and margin of $97.1 million and 33.4%, 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 changes I just discussed; an increase in Selling and Administrative expenses associated with separating and standing up embecta to operate as a publicly traded company; an increase in Research and Development expenses related to our insulin patch pump program; as well as an increase in the amount of certain one-time separation related expenses that we do not anticipate reoccurring in the future.

While on an adjusted basis, during the third quarter of 2023, operating income and margin totaled $79.8 million and 27.9%.

The adjusted operating income and margin performance during the third quarter of 2023 was better than we previously anticipated, and this was due to the overachievement at the adjusted gross profit and margin line that I referenced earlier.

Turning to the bottom line.

GAAP net income and earnings per diluted share was $15.2 million and $0.26 during the third quarter of fiscal 2023. This compared to $62.4 million and $1.07 in the prior year period.

The decline in year-over-year GAAP net income and diluted earnings per share is primarily due to the GAAP operating profit drivers I just discussed, as well as an increase in year-over-year interest expense associated with our variable interest rate debt.

While on an adjusted basis, net income and earnings per share were $39.8 million and $0.69 during the third quarter of fiscal 2023.

Lastly from a P&L perspective, for the third quarter of 2023 our adjusted EBITDA and margin totaled approximately $92.2 million and 32.2%.

Like our adjusted operating profit, due to the revenue and gross profit overachievement in the quarter, our adjusted EBITDA during Q3 also exceeded our previous expectations.

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

As of June 30th, 2023, we held approximately $317 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 3.4x.

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

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

Beginning with revenue.

Given our year-to-date performance, we are tightening our constant currency revenue guidance range, as we are now calling for full year 2023 constant currency revenue growth of between 0.5% and 1%. This is an increase of 50 basis points on the low-end, with about half of the increase due to our core injection business, and about half due to contract manufacturing revenue.

As it relates to the contract manufacturing of non-diabetes products that are sold to BD, our updated full year constant currency revenue range assumes no additional revenue associated with this during the fourth quarter. This compares to approximately $10 million of contract manufacturing revenue that was generated during the fourth quarter of 2022.

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

Turning to our thoughts on F/X, they remain unchanged from our previous expectations, and as such, our updated guidance continues to call for a foreign currency headwind of approximately 2.5% during 2023.

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

All totaled, our updated full year revenue guidance range implies the following for the fourth quarter:

- An as-reported revenue decline of between 2.4% on the low-end and 0.4% on the high-end
- An F/X headwind of approximately 0.1% on both the low and high ends
- And a constant currency revenue decline of between 2.3% on the low-end and a decline of 0.3% on the high-end

This implied constant currency range includes a headwind of approximately 3.6% related to the lack of contract manufacturing revenue in Q4; while we anticipate that our core injection business will grow between 1.3% and 3.3% on a constant currency basis. The expected acceleration in constant currency revenue growth within our core injection business during the fourth quarter is largely attributed to our anticipated performance in both the U.S. and China.

Moving to margins.

Based on the performance that was achieved year-to-date, we are raising our expectations for adjusted gross, adjusted operating, and adjusted EBITDA margins, as we now anticipate that our adjusted gross margin will be approximately 66.0%, up from our prior guidance of approximately 64.5%; our adjusted operating margin is expected to be approximately 29.5%, up from our prior guidance of approximately 28.0%; while our adjusted EBITDA margin is now projected to be approximately 33.5% for full year 2023, up from our previous guidance of approximately 32.5%.

Our updated guidance ranges imply a sequential step down in our margin profile from the third quarter to the fourth quarter and this is expected to occur due to a combination of factors, including lower anticipated revenue dollars in Q4 versus Q3, and the associated negative manufacturing variances; the ongoing temporary suspension of our manufacturing operations of our facility in China; unfavorable product mix; and incremental stand-up costs and F/X headwinds.

Continuing down the P&L, we currently expect that our net interest expense will be approximately $112 million, or slightly favorable as compared to our previous expectation which called for interest expense of approximately $113 million during 2023.

While our assumptions regarding our non-GAAP tax rate and weighted average shares remain unchanged at approximately 25% and 57.7 million shares, respectively.

At the bottom line this translates into our new full year 2023 adjusted earnings per diluted share range of between $2.75 and $2.80, which is an increase from our previous range of between $2.50 and $2.60; or a raise of approximately $0.23 at the mid-point.

In summary, the better than previously anticipated performance in the third quarter is translating into our increased full year financial guidance, as our thoughts regarding the fourth quarter are largely unchanged from when we last provided guidance in May.

In closing, during the first nine months of the year, we made good progress in each of our three major strategic priorities, including strengthening the base business; separating and standing ourselves up as an independent entity; and investing in growth initiatives, and it has been the focus on execution by our global team, and the resiliency of our base business, that has allowed us to generate solid financial performance, thereby allowing us to raise our financial guidance following each quarter of the year to date.

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