Embecta Corp.
Q4 and FY 22 Earnings Call Script
December 20th, 2022

Operator:
Please standby. Welcome, ladies and gentlemen, to the fiscal fourth quarter and full year 2022 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:
Good morning, everyone and welcome to embecta's fiscal fourth quarter and full year 2022 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 plan for today's call is as follows:

- Dev will start by making a few opening remarks on the overall performance of our business;
- Jake will then provide a more in-depth review of financial results for the fiscal fourth quarter and full year 2022, as well as our preliminary financial guidance for fiscal year 2023;
- Dev will then provide some closing thoughts on our strategic imperatives for fiscal 2023, and 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.

<u>Dev Kurdikar:</u>

Good morning everyone and thank you for joining us today.

Turning to slide 4, let me begin by reminding everyone who we are.

embecta is a leading global medical device company focused on providing solutions to improve the health and well-being of people living with diabetes, and we believe that our products have become one of the most widely recognized and respected brands in insulin injection devices used for diabetes management.

We have a broad portfolio of products, which we estimate are used annually by nearly 30 million people in over a 100 countries for insulin administration and to aid with the daily management of diabetes.

As a newly independent entity, we are an organization with a truly unique opportunity to become the pre-eminent diabetes-focused company in the world.

Moving to slide 5, we debuted on the Nasdaq Stock Market on April 1, 2022, and as an independent, diabetes-pure play company, we can build upon the foundation established by BD over almost one hundred years ago.

We intend to leverage our position as the global leader in insulin injection devices to invest in growth as we expand our portfolio through research and development, acquisitions, and partnerships to make better diabetes management solutions available to more people around the world.

We were proud to celebrate this year's Diabetes Awareness Month by ringing the Nasdaq Opening Bell on November 1st along with representatives of several organizations that make supporting the people who are living with diabetes their sole focus.

Our company is honored to recognize the people with diabetes, caregivers, healthcare providers, and advocacy organizations working together to improve access to education, and continue to progress towards the vision of a life unlimited by diabetes.

Thanks to the strong execution of our dedicated global team, during the second half of fiscal 2022 our core business remained on track while we progressed through our separation from BD, and this occurred notwithstanding the challenging macro-environment that our team had to navigate through.

Our teams have made notable progress in standing up new systems, processes, and regional offices so that we can exit the transition service agreements that we have in place with BD, while taking great care to minimize the impact that separation and stand-up oriented activities could have had on our customers and people with diabetes who need and use our products each and every day.

We are committed to investing behind organic new product development, and remain excited about the progress we are making in terms of our insulin patch pump that is being developed specifically for the Type 2 market.

Finally, we continue to seek partnerships and acquisitions where we can use our manufacturing strengths and commercial capabilities to add value.

I am pleased to say that we were recently active on this front, as we signed a co-promotional agreement with Intuity Medical under which our sales representatives will promote Intuity's innovative POGO Automatic Blood Glucose Monitoring System to select healthcare professionals in the U.S.

The agreement to promote POGO Automatic to healthcare professionals not only enables us to expand our offerings to physicians we call on, but it does so within the innovative new category of automatic blood glucose monitoring.

In addition to the co-promotional agreement with Intuity, we also signed similar agreements, albeit smaller in size, with companies in China and France, which leverage our existing commercial capabilities.

Now let’s move to slide 6 and look at our second half of 2022 financial guidance and compare it to our actual results.

Beginning in May, we provided initial financial guidance for the second half of fiscal year 2022 which called for revenue of approximately $555 million, which at the time represented an as-reported revenue decline of approximately 7%, and a constant currency revenue decline of approximately 3.5%. At that time, we also expected to achieve adjusted gross and adjusted EBITDA margins in the low-60s and low-30s, respectively.

In conjunction with our fiscal third quarter earnings conference call in August, we maintained our as-reported revenue dollar expectations. However, we raised our constant currency revenue expectations, as well as our guidance for both adjusted gross and adjusted EBITDA margins.

I am pleased to announce that for the second half of 2022, we generated approximately $566 million in revenue, which represented a decline of approximately 5.1% on an as-reported basis, and a decline of 1.2% on a constant currency basis. This was better than our August guidance primarily due to our constant currency revenue performance, as the FX impact was largely aligned with our guidance.

Our second half of 2022 revenue results were better than anticipated due to our performance in North America and EMEA, as well as more than anticipated contract manufacturing revenue with BD. The better-than-expected revenue performance in the quarter was somewhat offset by greater than anticipated COVID-19 restrictions that impacted our business in China.

Like revenue, our adjusted gross and adjusted EBITDA margins for the second half of 2022 also exceeded our already increased guidance, as we generated adjusted gross margin of 67.2%, and adjusted EBITDA margin of 36.3%.

The better-than-expected margin performance was primarily due to a combination of favorable geographic and product mix, as well as the timing of certain operating expenses associated with standing-up embecta as an independent company.

That completes my summary concerning 2022.

With that, let me turn the call over to Jake to discuss our Q4 and full year 2022 financial results in a bit more detail, as well as provide our preliminary fiscal 2023 financial guidance and underlying assumptions.

Thank you, Dev, and good morning, everyone.

Before I discuss the financial results for the three and twelve-month periods ending September 30th, 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, financial results for the three and twelve-month periods ending September 30, 2022, and September 30, 2021 are not meaningfully comparable.

Given the fact that embecta's historical financial results for the pre-spin periods do not include all the actual expenses that would have been incurred had embecta been a standalone public company during the periods presented, I plan on focusing the majority of my time today discussing embecta's preliminary fiscal 2023 financial guidance and underlying assumptions.

Turning to slide 7 and beginning with revenue.

During the fourth-quarter revenue totaled $274.6 million, which represented a decline of 8.7% on an as-reported basis, and 4.2% on a constant currency basis.

The decline in Q4 constant currency revenue, which was expected and something we foreshadowed on our third quarter earnings conference call, was primarily due to unfavorable comparisons stemming from a rebate reserve reversal which had occurred in the prior year period, coupled with decisions we made to exit certain legacy customer relationships at the very end of fiscal year 2021, as well as the timing of certain distributor orders in United States which positively impacted our revenue in Q3.

These headwinds were partially offset by revenue generated related to the contract manufacturing of non-diabetes related product that was sold to BD, which did not exist in the prior year period.

In comparison to our prior expectations, Q4 2022 revenue came in better than we previously anticipated, largely due to better volumes within North America and EMEA, as well as more than anticipated contract manufacturing revenue with BD.

The better-than-expected revenue performance in the quarter was somewhat offset by greater than anticipated COVID-19 restrictions that impacted our business in China..

From a regional standpoint, during Q4 U.S. revenues totaled $149.9 million which represented a decrease of 5.9% on both an as reported and constant currency basis. The year-over-year decline in the U.S. was primarily due to the unfavorable comparison stemming from the rebate reserve reversal which had occurred in the prior year period, as well as the aforementioned timing of certain orders which occurred in Q3. These headwinds were partially offset by contract manufacturing revenue which did not exist in the prior year period.

While International revenues totaled $124.7 million, or a decrease of 11.9% on an as reported basis and 2.3% on a constant currency basis. The year-over-year decline in our International business was primarily due to decisions we made to exit certain legacy customer relationships at the very end of fiscal year 2021.

For the full year, embecta's revenues totaled approximately one billion one hundred thirty million, which was down approximately 3.1% on an as reported basis, or down 0.5% on a constant currency basis.

The drivers of the slight full year 2022 constant currency revenue decline were similar to the items that impacted our fourth quarter, including the prior year rebate reserve reversals which did not occur to the same extent in 2022, the decisions we took towards the very end of fiscal year 2021 to exit certain legacy customer relationships, as well as COVID-19 restrictions in certain geographies. These headwinds were somewhat offset by contract manufacturing revenue which did not exist in the prior year.

Moving to slide 8 and a review of some of our remaining key financial indicators for the fourth quarter.

GAAP and adjusted gross profit and margin for the fourth quarter of 2022 totaled $176.9 million and 64.4%, respectively. This compares to $209.7 million and 69.7% in the prior year period.

Like revenue, the year over year decline in gross margin during the fourth quarter was expected and primarily due to:

- Contract manufacturing and supply agreement impacts, most notably the impact of increased cannula costs
- Product and geographic mix
- Incremental investments and stand-up costs
- And the continued negative incremental impacts of inflation and increased labor and material costs

Additionally, like my comments concerning revenue, our adjusted gross margin performance in the fourth quarter also exceeded our previously provided guidance which called for adjusted gross margins to be in the "low-60s" during Q4.

Turning to the bottom line, during the fourth quarter of 2022 we incurred a GAAP net loss of $17.2 million, as compared to net income of $97.1 million in the prior year period.

The year over year decrease of approximately $114 million is primarily due to:

- The reduction in gross profit dollars that I just referred to;
- The incurrence of separation and stand-up expenses related to embecta becoming its own publicly traded company;

- Interest expense that was incurred in the fourth quarter of fiscal 2022, as compared to zero in the prior year period;
- As well as a non-cash impairment charge of $58.9 million associated with the decision to abandon certain manufacturing production lines in the United States, and $5.5 million of costs incurred related to purchase commitments, which was also related to the decision to abandon those same manufacturing production lines.

As some additional background, the impaired assets were previously included as a component of construction in progress within Property, Plant, and Equipment on our balance sheet. These assets were transferred to embecta in conjunction with the spin, were never placed into service, and were related to certain diabetes syringe manufacturing production lines.

These impaired assets were in no way associated with our insulin patch pump, which continues to progress in its development.

Lastly from a P&L perspective, for the fourth quarter of 2022, our adjusted EBITDA and margin totaled approximately $87.2 million and 31.8%. This compares to $131.6 million and 43.8% in the prior year period.

Due to the slight overachievement at the adjusted gross margin line, our adjusted EBITDA margin for the fourth quarter of 2022 also came in a bit better than we previously expected.

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

As of September 30th, 2022, we held approximately $331 million in cash and cash equivalents, and approximately $1.65 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 second half of fiscal 2022.

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

Beginning with revenue on Slide 9.

On a constant currency basis, we currently anticipate that our revenues will be flat to down 2% as compared to 2022.

At the low-end of the guidance range, we are assuming about one half of the decline will result from reduced contract manufacturing revenue of non-diabetes care products 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 lingering COVID-19 restrictions like those we saw impact our business in China during the latter part of 2022.

While the high-end of our constant currency revenue range assumes 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.

Given how new the partnership agreements are that we were able to execute, we assumed an immaterial amount of revenue associated with them as part of our 2023 revenue guidance range.

Turning to our thoughts on F/X.

embecta has a larger presence outside of the United States than many other companies of our size, and as such, our initial guidance calls for a foreign currency headwind of approximately 5% during 2023.

This assumption is based on foreign exchange rates that were in existence around the mid-November timeframe, including a Euro to U.S. Dollar exchange rate of approximately 0.98.

On a combined basis, our as-reported revenue guidance calls for a decline of between 5% and 7%, resulting in an initial revenue guide of between $1.05 billion and $1.073 billion.

Turning to adjusted gross margin, I will be comparing 2023 against our Q4 2022 jump-off point, as our fourth quarter 2022 adjusted gross margin is the most representative to date of our business as an independent entity.

During 2023 we currently anticipate that our adjusted gross margin will be approximately 62%, or a decline of about 240 basis points as compared to Q4 2022, with the largest drivers being:

- Additional stand-up costs, inclusive of various regulatory, quality, supply chain, and manufacturing expenses, as we continue to invest in these capabilities in advance of exiting the TSAs
- Increased raw material costs, including those associated with the cannulas that we purchase from BD
- And continued headwinds because of inflation

We estimate that additional stand-up costs, and increased material costs, will drive the majority of the adjusted gross margin change, while despite several cost improvement programs that are underway at the Company, we expect inflationary pressures to make up the remainder of the adjusted gross margin fluctuation.

Continuing down the P&L, we expect that we will maintain adjusted SG&A near a 30% level, despite periods of time during 2023 in which we may incur a combination of both TSA expense and stand-up costs.

While we also intend to invest more heavily in R&D, most notably behind our Type-2 insulin pump development program, and because of this, R&D as a percentage of revenue may exceed 7% during 2023.

All totaled, we anticipate that our adjusted operating margin during 2023 will be approximately 25%, which is near best-in-class as compared to other med-tech companies of our revenue size.

Moving to earnings, during 2023 our initial guidance calls for an adjusted diluted earnings per share range of between $1.75 and $2.00.

This includes an assumption that our annual net interest expense will be between $115 million and $120 million; that our annual adjusted tax rate will be approximately 25%; and that we will have approximately 57.7 million weighted average diluted shares outstanding.

With respect to our interest expense expectations, our full year guidance assumes that SOFR will continue to increase as we move throughout the year, peaking near 5.25%. As a reminder, our capital structure is comprised of approximately $950 million of term loan B debt, which is a floating rate instrument, bearing interest at SOFR plus 300 basis points; and approximately $700 million of senior secured notes, which are fixed rate instruments.

While from a tax rate standpoint, our 25% adjusted tax rate assumption is based on a few key variables, including the geographic mix of global earnings by legal entity, as well as limitations associated with U.S. interest expense deductibility.

Finally, from a guidance standpoint, that takes to me to adjusted EBITDA margin, which we expect to be approximately 30% during 2023.

The adjusted EBITDA margin in 2023 is expected to be down from the levels achieved during the fourth quarter of 2022, largely due to the gross margin items I mentioned earlier, coupled with very deliberate investments we intend to make within R&D, which we are willing to do to accelerate our constant currency revenue growth rates sustainably in the future.

And before I turn the call over to Dev for some final remarks, I'd like to highlight some considerations regarding the cadence of quarterly revenue expectations during 2023 and briefly touch on our previously provided 2024 financial objectives. Moving forward, we may not provide any further commentary concerning the quarterly cadence of revenue on an ongoing basis.

During fiscal year 2022, we generated approximately 50% of our as-reported revenue dollars during the first half of the year, including approximately 26% during the first quarter.

During 2023, we currently anticipate generating a slightly lower percentage of our annual revenue during both the first quarter and first half of 2023, as compared to the prior year periods.

Lastly, as it relates to the 2024 financial goals and objectives that we provided to the investment community in March of this year prior to spin, we remain committed to the achievement of those objectives, including maintaining an adjusted EBITDA margin of approximately 30% in 2024. And this comes despite a significantly more challenging operating environment as compared to the one that existed when we originally provided those targets, including inflation at near forty-year highs, rising interest rates, as well as additional foreign exchange headwinds.

That completes my prepared remarks, and at this time, I would like to turn the call back over to Dev for some final remarks.

DEV:

Thank you, Jake.

Wrapping up our discussion on Slide 10, you will see that our 2023 priorities are set with the intention to solidify our business and make investments in our strategic imperatives to accelerate our long-term growth profile.

- First, we will continue to strengthen our base business while maintaining our global leadership position in the category of insulin injection devices. We do anticipate facing many of the same macroeconomic factors that continue to impact the industry. Our performance to-date reflects the non-elective nature of our products and the resilience of our business model, which will help us in navigating through the challenging operating environment.
- Second, we will continue to incur costs as we stand up our own public company, including expenses associated with the creation of various corporate functions and infrastructure including an ERP system. Also, as part of the separation from BD, we anticipate a temporary suspension of manufacturing operations associated with the regulatory approvals and transitions, including for inspections, at our Suzhou, China facility in the second half of fiscal 2023. This was an anticipated action item at the time of spin-off for transitions from BD over to embecta.

- And finally, we intend to increase our investment in R&D – and we remain excited about our patch pump that is being developed for the Type 2 market. At the same time, we plan to continue to seek partnerships and acquisitions where we can use our manufacturing strengths and commercial capabilities to add value.

In closing, I would like to extend my thanks to all of my colleagues around the globe for everything they have done, and continue to do, to serve people with diabetes while we stand up embecta as an independent company. Their dedication to our mission serves as a source of embecta's strength.

That completes my remarks.