Embecta Corp.
Q2 FY 24 Earnings Call Script
May 9th, 2024

Please standby. Welcome, ladies and gentlemen, to the fiscal second quarter 2024 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 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 second quarter 2024 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 some remarks on the overall performance of our business during the fiscal second quarter of 2024; as well as an overview of our strategic priorities;
- Jake will then provide a more in-depth review of our Q2 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.

Dev….

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

Let's start with our strategic priorities on Slide 5.

We remain committed to the same trio of strategic priorities that have guided us since we established ourselves as an independent company.

These priorities form the basis of our decisions and actions and they are:

- Remaining focused on strengthening our base business, while maintaining our global leadership position in the category of insulin injection devices

- Separating ourselves from our former parent in a thoughtful manner to mitigate risk and position us for long-term success as an independent company

- And finally, 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.

During this past quarter, we made significant progress within each of these goals.

Turning to some second quarter highlights.

The second quarter was a strong quarter for embecta, one in which we generated approximately $287 million in revenue, which represented an increase of 3.6% on an as-reported basis and 4.5% on a constant currency basis. When normalizing for the transient contract manufacturing revenue that we generate based on the sales of non-diabetes products to our former parent, our constant currency revenue grew 4.9% as compared to the prior year period.

This solid performance exceeded our expectations and occurred while simultaneously implementing our own ERP system, operationalizing our new distribution network including 7 new distribution centers, and standing up shared service capability in markets comprising 25% of our revenue in over 100 countries and serving approximately 5,000 customers. We also implemented these systems and processes in our third manufacturing plant.

Thus, at the end of the second quarter, we have completed the implementation of our ERP system and operationalized our distribution network and shared service capability across approximately 85% of our revenue base servicing customers in US, Canada, EMEA and parts of Asia, and, at all three of our manufacturing plants in the U.S., Ireland and China.

Additionally, we successfully completed the remaining steps in the demerger process for our manufacturing entity in China and have transitioned its legal ownership from BD to embecta. We have also resumed manufacturing at this facility for products for supply to our customers in China. We have previously commented that this facility was producing goods for export to other markets, so now the plant is fully operational.

All of these accomplishments were achieved in alignment with our projected timelines. The transfer of ownership of this important plant from BD to embecta, and the restarting of domestic China production, marks the completion of a significant separation project that our team has been meticulously working on since prior to our spin-off date.

Lastly as it relates to separation activities, to facilitate the phased implementation of our ERP solution, distribution network, and shared service capabilities, we had requested an extension for certain TSAs and related agreements from BD. BD granted that limited extension which has allowed us to implement our ERP system and associated distribution and shared services capabilities in a phased manner with the goal of completing these implementations in all markets except in certain limited deferred closing jurisdictions by early fiscal year 2025.

It goes without saying that these implementations are highly intricate, and I'm proud of our team for bringing these complex projects to near completion.

Related to our objective of entering the infusion pump market, we sponsored the publication of a paper titled "Opportunities to overcome underutilization of enhanced insulin delivery technologies in people with type 2 diabetes: a narrative review". This paper aims to inform healthcare providers, particularly primary care physicians and those less familiar with technology, about the benefits of insulin pumps for people with Type 2 diabetes. It highlights the safety and effectiveness of innovative technologies like insulin delivery systems in improving glycemic outcomes. Despite the proven efficacy, these technologies are often overlooked in primary care settings. The review explores the clinical and economic advantages of tubeless insulin delivery devices and explains how this technology can address common challenges associated with traditional insulin delivery methods.

And speaking of insulin patch pumps, we continue to make progress in terms of our insulin patch pumps that are being developed. I'll share more about these accomplishments in the following slide.

To summarize, during the second quarter, strong operational execution led to results that exceeded our internal expectations, and based on these results, we are raising and tightening our guidance range for key financial metrics which Jake will be discussing later.

Turning to the advancements we made in terms of our insulin patch pump program.

Our 510(k) application for the open-loop version of our insulin patch pump continues to be under FDA review and we continue to have ongoing dialog with the FDA. As a reminder, we submitted our 510(k) application to the FDA in late calendar year 2023.

In parallel, during the second quarter we also continued the development of a closed-loop insulin patch pump that is targeted towards those individuals who have type 2 diabetes, including further collaborating with Tidepool concerning the adaptation of their FDA-approved type 1 algorithm, into a type 2 algorithm that could be used in our closed-loop insulin patch pump system.

As we continue to progress throughout this year, we will continue to provide updates to the investment community regarding the status of the FDA's review at the appropriate times, as well as progress we make regarding our closed-loop, type 2 patch pump.

Lastly, I would like to provide a review of our second quarter revenue performance in a bit more detail.

As I mentioned at the outset, during Q2 we generated revenue of $287.2 million, which represented an increase of 3.6% on an as-reported basis, and an increase of 4.5% on a constant currency basis, or 4.9% when normalizing for the impact of year-over-year changes in the revenue of the non-diabetes products that we contract manufacture and sell to BD.

Our Q2 revenue exceeded our previously communicated expectations primarily due to the timing of customer orders in advance of our afore-mentioned EMEA and parts of Asia focused ERP system and associated capabilities implementations and in advance of a price increase in the U.S. Q2 revenue also benefited from a better than expected product and geographic mix.

We estimate that the timing of customer orders impacted our second quarter results positively by approximately $16 million and we currently expect that the timing benefit will unwind during fiscal Q3.

Within the U.S., during the quarter revenue totaled $147.6 million, which represented year-over-year growth of approximately 0.8% on a constant currency basis. When normalizing for year-over-year contract manufacturing revenues, our underlying Q2 constant currency revenue growth within the U.S. was approximately 1.5%. Volume was the primary contributor of growth in the quarter, aided by our contract wins with the top three Medicare Part D plans going into effect in January 2024. As we have previously noted, we are the preferred or dual preferred brand on the formularies of these plans. These additional Medicare Part D plan volumes were somewhat offset by the unwinding of certain customer orders that benefited us in our fiscal first quarter, as was discussed on our first quarter earnings call. Pricing was flat in the quarter as compared to the year-ago period, which was as expected.

During Q2 our International revenue totaled $139.6 million, which equated to year-over-year constant currency growth of approximately 8.7%. Growth in our International business was due to increased volumes and can be largely attributed to the timing of certain customer orders in advance of previously mentioned ERP and associated capabilities implementations that occurred within the quarter. Pricing within our International business remained relatively flat.

That completes my prepared remarks, and with that, let me turn the call over to Jake to take you through our second quarter financial results, as well as our updated full year financial guidance in more detail.

Jake…

Thank you, Dev, and good morning, everyone.

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

GAAP gross profit and margin for the second quarter of fiscal 2024 totaled $185.4 million and 64.6%, respectively. This compared to $189.8 million and 68.5% in the prior year period.

While on an adjusted basis, our Q2 2024 adjusted gross profit and margin totaled $185.8 million and 64.7%. This compared to $190.1 million and 68.6% in the prior year period.

The year-over-year decrease in adjusted gross profit and margin was due to the impact of inflation on the costs of certain raw materials, direct labor, freight and overhead; the impact of negative year-over-year manufacturing variances primarily attributable to the planned temporary shutdown of our Suzhou, China facility as it relates to production for the domestic Chinese market for part of the quarter; and the negative impact of foreign currency translation, primarily due to the strengthening of the U.S. dollar.

As compared to our prior outlook, our adjusted gross margin during the second quarter was better than we previously expected, and this was due to the higher than anticipated revenue that Dev referred to earlier, as well as favorable geographic and product mix.

Turning to GAAP operating income and margin, during the second quarter they were $39.2 million and 13.6%. This compared to $55.6 million and 20.1% in the prior year period.

While on an adjusted basis, our Q2 2024 adjusted operating income and margin totaled $74.9 million and 26.1%. This compared to $84.9 million and 30.6% in the prior year period.

The year-over-year decrease in adjusted operating income and margin is primarily due to the adjusted gross profit changes I just discussed, as well as an increase in SG&A

costs associated with standing-up the organization. These additional costs were somewhat offset by a reduction in year-over-year R&D expense, primarily due to an upfront payment made in the prior year period in connection with the Tidepool algorithm collaboration agreement, as well as a reduction in TSA expenses.

The adjusted operating income and margin performance during Q2 was better than we previously expected, primarily due to the over-achievement at the gross margin line; coupled with the timing of R&D spending within the quarter.

Turning to the bottom line.

GAAP net income and earnings per diluted share were $28.9 million and $0.50 during the second quarter of fiscal 2024, which compared to $14.0 million and $0.24 in the prior year period.

While on an adjusted basis, net income and earnings per share were $38.9 million and $0.67 during the second quarter of fiscal 2024. This compared to $43.3 million and $0.75 in the prior year period.

The decrease in year-over-year adjusted net income and diluted earnings per share is primarily due to the adjusted operating profit drivers I just discussed; as well as an increase in year-over-year interest expense associated with the rise in SOFR, and the impact that had on our variable interest rate debt. This was somewhat offset by a reduction in our adjusted tax rate from approximately 25% in Q2 of 2023 to approximately 17.9% in Q2 of 2024. The year-over-year reduction in our adjusted tax rate was expected and was due to certain discrete tax items that occurred during the quarter. For the first six months of 2024, our adjusted tax rate was approximately 22%, which is in-line with our annual adjusted tax rate expectations.

Lastly from a P&L perspective, for the second quarter of 2024 our adjusted EBITDA and margin totaled approximately $90.8 million and 31.6%. This compared to $96.7 million and 34.9% in the prior year period.

Turning to the balance sheet and cash flow.

At the end of the second quarter, our cash balance totaled $306.5 million, while our last twelve months net leverage as defined under our credit facility agreement stood at approximately 3.8x. As a reminder our net leverage covenant requires us to stay below 4.75x.

From a cash flow perspective, our cash balance as of March 31st is approximately $20 million lower than the balance that existed as of September 30th and this is largely attributed to cash that has been used related to separation related activities, which include: (i) product registration and labeling costs; (ii) warehousing and distribution set-up costs; (iii) legal costs associated with patents and trademark work; (iv) temporary headcount resources within accounting, tax, finance, human resources, regulatory and IT; and (v) one-time business integration and IT related costs primarily associated with our global ERP implementations. We estimate that during the first six months of fiscal year 2024 we used approximately $90 million of cash towards these separation activities.

As we look forward, we currently estimate that we will end fiscal year 2024 with a cash balance roughly comparable to the balance that existed at the end of the second quarter. This includes an expectation that for the full year, we will use between approximately $180 and $190 million of cash towards separation activities. This compares to cash used for separation activities of approximately $145 million during fiscal year 2023.

Given that we expect to be complete with most separation projects, by the end of this fiscal year, we would expect to see an improvement in our cash balances in fiscal year 2025 and beyond, which would allow us additional flexibility in terms of capital allocation, including debt repayment.

Additionally, we now show trade receivables globally on our balance sheet given our previously mentioned ERP implementations, and the exit of our factoring agreements with BD.

I'm pleased to report that following the implementation of our ERP system and shared services functionality in November of 2023 within North America, that the cash collections associated with those receivables have continued to trend in a positive direction and that this has returned to a more typical levels of accounts receivables within North America. This is important as it will allow us to focus our attention on the newly generated accounts receivable that exist within EMEA and Asia and turning those receivables into cash following our March of 2024 ERP implementations and shared service capabilities in those regions.

That completes my comments on our fiscal Q2 results.

Next, I will provide an update on our full year 2024 financial guidance.

Beginning with revenue.

Given our performance during the first half of the year, we are tightening our constant currency revenue guidance range, as we are now calling for full year 2024 constant currency revenue to be flat to down 0.5% as compared to 2023. This compares to our prior guidance range which called for full year constant currency revenue to be flat to down 2% as compared to the prior year, or an increase of approximately 75 basis points at the mid-point.

The low-end of our updated constant currency revenue growth guidance range is driven entirely by year-over-year headwinds associated with reduced contract manufacturing revenue of non-diabetes products, as we now expect our underlying core injection diabetes product revenues to be flat, compared to a 1% decline assumed in our prior guidance.

While the high-end of our constant currency revenue range is unchanged as compared to our prior guidance.

Turning to F/X, we are reaffirming our previously provided guidance which called for foreign currency to be a headwind of approximately 0.4% versus the prior year.

These F/X assumptions are based on foreign exchange rates that were in existence in the late-April timeframe, including a Euro to U.S. Dollar exchange rate of approximately 1.08.

On a combined basis, our updated as-reported guidance range calls for revenue to be down between 0.4% and 0.9% as compared to 2023, resulting in an updated revenue guide of between $1 billion 111 million and $1 billion 116 million.

Turning to margins.

We are raising the mid-point of our adjusted gross, adjusted operating, and adjusted EBITDA margin guidance by 125 basis points each, as we now expect adjusted gross margin of between 64.5% and 65%; adjusted operating margin of between 25.25% and 25.75%; and adjusted EBITDA margin of between 31.0% and 31.5%.

Finally, due to a combination of an improved revenue and margin outlook, we are increasing our adjusted earnings per share guidance from a range of between $1.95 and $2.15, to a new range of between $2.20 and $2.30, or an increase at the mid-point of $0.20.

Our updated guidance range continues to assume that our annual net interest expense will be approximately $116 million; that our annual adjusted tax rate will be approximately 22%; and that our weighted average diluted shares outstanding will be approximately 58.1 million.

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

As we wrap up the call, I want to extend my heartfelt appreciation to all my colleagues at embecta across the globe. In the last two years since our spin-off, our team has worked non-stop on executing our strategic priorities including major separation related programs while never wavering from our mission of developing and providing solutions that make life better for people living with diabetes.

Thank you all for attending the call and for your interest in our business.