Operator:
Please standby. Welcome, ladies and gentlemen, to the third quarter of Fiscal Year 2022 Earnings Conference Call for embecta corp.

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 shortly.

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

Pravesh Khandelwal:
Thank you, operator. Good morning, everyone. Thank you for joining our fiscal third quarter 2022 earnings call. With me today are Dev Kurdikar, embecta's Chief Executive Officer; and Jake Elguicze, our Chief Financial Officer.

Before we begin, I would like to caution listeners that certain information discussed by management during this conference call will include forward-looking statements within the meaning of the federal securities laws, which may be identified by words like anticipate, expect, may, believe, estimate, and other similar words, and it is possible actual results could differ from management's expectations. As stated in more detail in our accompanying slides, these forward-looking statements include statements concerning our costs and growth opportunities, our cash flow and expected use, and our financial performance (including sales, margins and earnings), and also include statements concerning future dividends. Risks, uncertainties and other factors that could cause such differences can be found in the Company's earnings release and latest SEC filings, including the Information Statement dated February 11, 2022 filed as

Exhibit 99.1 to the Company's Current Report on Form 8-K and Form 10-Qs. 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 the press release and conference call presentation.

Unless otherwise specified, all comparisons will be on a year-over-year basis versus the relevant period. Revenue percent changes are on an FX-neutral basis, unless otherwise noted. When management refers to any given period, they are referring to the fiscal period, unless specifically noted as a calendar period.

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

Starting on Slide 3, Our plan for today's call is as follows:

- Dev will make a few opening remarks on the overall performance of our business
- Jake will provide you with a more in-depth review of financial results for the third quarter of fiscal 2022, as well as our updated financial guidance as stated in our earnings press release issued earlier today.
- Dev will then provide some closing thoughts on our strategic imperatives
- We will then open the call for questions.

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

Dev Kurdikar:

Good morning everyone and thank you for joining us today for embecta's third quarter of fiscal year 2022 earnings call, which also marks our first full quarter as a standalone public company.

Before we get into the content of today's call, let me also welcome Pravesh Khandelwal whom you just heard. Pravesh has joined us as our Vice President of Investor Relations. He was most recently in investor relations at a healthcare company and has prior experience in equity research. We are excited to have him join our team.

Turning to slide 5, let me first start with who we are. Quite simply, we are an organization with a truly unique opportunity to create the pre-eminent diabetes-focused company in the world. Our mission is to develop and provide solutions that make life better for people with diabetes. That is our entire focus.

We are the global leaders in the business of injection devices. We have been making and selling insulin injection devices for almost a hundred years, our global manufacturing infrastructure is unmatched, and supported by a geographically diverse sales and distribution network.

We have built an incredible leadership team to advance our vision of empowering people to live a life unlimited by diabetes. We have recently added to our leadership talent by recruiting experienced leaders for our regulatory affairs, R&D and quality functions – roles critical for our current business as well as for achieving our longer term objectives. Our global team of 2000 employees have been hard at work standing up embecta, and driving our business for people with diabetes, for our customers, and for our stakeholders.

Switching to slide 6, Here are our financial and operating highlights for the third quarter of fiscal 2022.

We are pleased with the company's strong performance in the quarter, our first as a standalone public company, amidst the current challenging operating environment which includes having to navigate through raw material inflationary pressures, supply chain challenges, geo-political concerns, and varying Covid-19 restrictions.

This performance reflects the resilience of our business model, the defensive segment in which we operate, and most importantly, the character and determination of our global team that works tirelessly to serve our customers and people with diabetes who use our products.

An important nuance of this business is that our products are primarily single-use disposable products and hence their use is not significantly financially burdensome in contrast with some other therapies.

Moving to the financial results for this quarter, embecta generated revenues of $291.1 million. This represents a decline of 1.3% on an as-reported basis, and growth of 2.0% on a constant currency basis.

The constant currency revenue growth was primarily driven by higher volume and to a lesser extent price in the U.S. and in Central and Southeast Asia. I'll comment on geographic revenue breakdown on the next slide in a moment.

GAAP gross profit and margin for the third quarter of 2022 totaled $202.9 million and 69.7%, respectively. Adjusted gross and EBITDA margins remained robust, at 69.8% and 40.5%, respectively.

And based on our strong third quarter results, and outlook for the remainder of the year, we are raising our financial guidance for constant currency revenue growth, adjusted gross margin and adjusted EBITDA margin for the second half of this fiscal year, while reiterating our as-reported revenue growth guidance despite incremental FX headwinds.

Additionally, we continue to make progress building up our internal organization, systems and processes so that we can exit the transition services agreements that we have with Becton Dickinson within the planned time periods.

And lastly, we continued to advance the development of type 2 closed loop insulin delivery system utilizing our proprietary patch pump technology.

Now clicking through geographic revenues on slide 7, third-quarter U.S. revenues of $158.0 million increased by 4.1% on both an as reported and constant currency basis. International revenues of $133.1 million, decreased by 7.1% on an as reported basis and 0.3% on a constant currency basis. Overall constant currency growth of 2.0% was primarily due to an increase in base business volume, in part due to the timing of certain orders within the U.S.; the impact of contract manufacturing revenue to BD; and improved pricing. Somewhat offsetting this was a rebate reserve adjustment that occurred in the third quarter of 2021, which did not reoccur in the third quarter of 2022. And while we benefited from the timing of certain orders this quarter, we continue to focus on the second half business performance, as the timing and cadence of order patterns varies quarter to quarter.

On a year-to-date basis, revenues were $854.9 million. This represents a decrease of 1.1% on an as-reported basis, and an increase of 0.8% on a constant currency basis. Overall constant currency growth was driven by favorable price and volume, partially offset by the conscious decisions that we made during the latter portion of 2021 to no longer participate in certain business and which we discussed on our prior call.

With that, let me turn it over to Jake to discuss our Q3 results and our updated expectations for the second half of this year.

Thank you, Dev, and good morning, everyone.

Before I discuss the financial results for the three and nine-month periods ended June 30th, I would like to remind the investment community that embecta was spun-off from BD on April 1, 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 nine-month periods ended June 30, 2022, and June 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 most of my time discussing embecta's recently updated second half of fiscal 2022 financial guidance.

Turning to embecta's financial performance for the third quarter on Slide 8.

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

GAAP gross profit and margin for the third quarter of 2022 totaled $202.9 million and 69.7%, respectively. This compares to $202.6 million and 68.7% in the prior year period.

The 100 basis-point improvement in GAAP gross margin was primarily due to favorable product mix. This was partially offset by the negative impact of inflation on raw material costs, direct labor, and overhead.

While from an adjusted gross profit and margin perspective, for the three months ended June 30th, 2022, they totaled $203.1 million and 69.8%, respectively. This compares to 206.4 million and 70.0% in the prior year period.

Despite incurring additional costs associated with standing-up embecta as an independent entity, adjusted gross margin for the third quarter came in strong at approximately 70%, and this was better than we previously anticipated.

Turning to GAAP net income, during the third quarter of 2022 it totaled $62.4 million. This compares to $104.7 million in the prior year period.

The decrease of approximately $42 million is due to a combination of factors, which include:

- An increase in selling and admin expenses of approximately $23 million, which is driven by an increase in compensation and benefit costs due to increased headcount, and to a lesser extent, increases in marketing and advertising spend both attributed to the separation and embecta becoming a stand-alone publicly traded company

- A decrease in R&D of approximately $1 million, driven by the timing of certain spend

- And interest expense of approximately $20 million that was incurred in the third quarter of fiscal 2022, as compared to zero in the prior year period

Lastly, moving to adjusted EBITDA and margin, it totaled approximately $117.9 million and 40.5% for the third quarter of 2022. This compares to $143.6 million and 48.7% in the prior year period.

Like our performance at the adjusted gross margin line, our adjusted EBITDA margin for the third quarter of 2022 also came in better than we initially anticipated and it was primarily driven by:

- Revenue in the quarter being better than expected

- Favorable product and geographic mix positively impacting our gross margin

- And R&D expense being slightly lower than originally planned due to the timing of certain spend

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

As of June 30th, 2022, we held approximately $292 million in cash and cash equivalents, and approximately $1.65 billion in debt.

As we created our initial capital structure, and leverage levels, we tried to be mindful of our current financial profile; the need to increase the level of investment in the business; and shareholder returns.

We have a balance sheet that we can use to invest both organically, as well as use for M&A and partnerships opportunities, and as of June 30th, 2022, our last twelve-months ended net leverage ratio stood at approximately 2.8x.

Lastly, this morning we announced that our Board of Directors approved our inaugural cash dividend, which was set at $0.15 per share.

Given that our GAAP net income could fluctuate quarter to quarter, we attempted to arrive at a dividend per share amount that would approximate 20% of our second half of 2022 expected GAAP net income.

We took this approach to avoid quarter to quarter dividend per share fluctuations.

We think that we can provide this return to shareholders, while preserving the ability to increase the level of investment in the business to drive accelerated constant currency revenue growth rates in the future, all while maintaining a very strong liquidity profile.

That completes my prepared remarks as it relates to embecta's historical financial performance.

Next, I would like to outline embecta's updated financial guidance on Slide 9.

Beginning with certain key assumptions.

Unlike the first half of 2022 financial results, our second half of 2022 guidance attempts to take into consideration the various costs that embecta will incur moving forward as an independent, publicly traded company.

This includes various contract manufacturing agreements that we will have in place with BD, which result in third-party revenue for embecta at very little gross margin.

While certain other supply agreements are for inputs that embecta needs to obtain from BD, such as cannulas, which are used in embecta's product offerings.

In addition to these contract manufacturing and supply agreement impacts, our second half of 2022 financial guidance also assumes expenses that we will incur because of the lease of our Holdrege, Nebraska facility from BD; as well as expenses we will incur because of BD continuing to factor certain accounts receivable on embecta's behalf.

Furthermore, our second half of 2022 financial guidance also assumes six-month's worth of transition services expense related to a variety of activities that BD will perform for embecta.

The transition services expenses were determined, and costed out, at a very detailed line-item level. These TSAs can last for a period not to exceed two years and can be terminated earlier by embecta with a defined notice period.

As part of our second half of 2022 financial projections, we also included estimates associated with costs that we anticipate incurring as we stand up our own public company.

These costs include expenses associated with stock-based compensation, external audit fees, stock exchange listing fees, and most notably, the expenses associated with the creation of various corporate functions and infrastructure, such as, finance, treasury, tax, HR, IT, legal, supply chain, regulatory and quality, etc.

Moreover, as we prepared and updated our second half of 2022 financial guidance, we also attempted to take into consideration the impact that COVID-19 is still having on certain markets; continued geo-political concerns; as well as the negative impact stemming from inflation and supply chain disruptions. We have attempted to give due consideration to these elements, but we realize that the future trajectory of these factors is unpredictable.

Lastly, given that approximately half of embecta's business is derived internationally, as well as the fact that several foreign currency exchange rates have changed significantly since we initially provided financial guidance for the second half of fiscal year 2022, I wanted to take a moment and highlight what we assumed for some of the key currency pairs that effect our business, those being the Euro/Dollar; Dollar/Japanese Yen; and Dollar/Chinese Yuan.

We based our updated second half of 2022 financial estimates on spot rates that existed near the beginning of August, including a Euro to Dollar rate of approximately 1.05 for the second half of the year, and approximately 1.02 in the fourth quarter; a Dollar to Japanese Yen rate of approximately 131 for the second half of the year, and approximately 136 in the fourth quarter; and a Dollar to Chinese Yuan rate of approximately 6.61 for the second half of the year, and approximately 6.71 for the fourth quarter.

These assumptions compare to second half of 2021 rates of approximately 1.19, 109, and 6.5, respectively.

Now that I have outlined some of our key assumptions, I would now like to take you through our updated financial guidance for the second half of fiscal 2022 and provide some perspective as to what some of the key drivers of change are as compared to our previously provided financial guidance.

Beginning with revenue, we are reaffirming our previously provided as-reported revenue amount, as we continue to expect to generate approximately $555 million during the second half of fiscal 2022.

This comes despite significant fluctuations in various F/X rates since we last provided guidance, which we now expect to be a headwind of approximately 4.0% in the second half of the year as compared to the prior year period, or an incremental F/X headwind of approximately 50 basis points as compared to our previous financial guidance.

While from a constant currency perspective, I am pleased to say that we are raising our expectations for the second half of the year by 50 basis points, as we now expect to see a decline of approximately 3.0% during the second half of fiscal 2022 as compared to the second half of fiscal 2021.

The raise in our constant currency revenue expectations for the second half of the fiscal year come even though we now expect to generate approximately 5 million dollars less of contract manufacturing revenue with BD.

Had the amount of contract manufacturing revenue remained consistent to our prior expectation, we expect that our constant currency revenue growth would have been better by an additional 80 basis points.

The ability for us to raise our constant currency guidance is due to our base business, which is performing slightly better than we initially anticipated.

Given that we only have one quarter left in fiscal 2022, our updated financial guidance for the second half of 2022 implies a fourth quarter revenue amount of approximately $264 million.

The sequential deceleration between Q3 revenue, and our expectations for Q4, are due to a combination of factors, including the timing of shipments and orders that Dev referenced earlier that positively impacted Q3, as well as larger expected sequential FX headwinds, being two of the primary drivers.

And when comparing Q4 against prior year results, it is important to understand that we are still dealing with uneven comps, given COVID-related peaks and troughs that impacted revenue timing in prior and current year periods.

That said, for the entirety of the second half of 2022 as compared to our previous guidance, our base business is expected to do slightly better, thereby allowing us to raise our constant currency revenue performance expectations.

Turning to adjusted gross margin.

We are raising our expectations for adjusted gross margin, as we now expect our adjusted gross margin to be in the "mid-60s" during the second half of this fiscal year. That compares to our initial guidance which called for second half of the fiscal year adjusted gross margin to be in the "low-60s".

Given our performance during the third quarter, this would imply that our fourth quarter adjusted gross margin would be in the "low-60s".

The expectation for a sequential decline in adjusted gross margin from Q3, to our forecast for Q4, is primarily due to:

- Contract manufacturing and supply agreement impacts, most notably the impact of increased cannula costs
- Product and geographic mix shifts between quarters
- Incremental investments and stand-up costs

- And the continued negative incremental impacts of inflation and increased labor and material costs

With each of these factors contributing approximately equally to the expected sequential decline in Q3 to Q4 adjusted gross margin.

Moving next to TSA expense.

Here, our thoughts are unchanged, as we continue to expect to incur approximately $35 million in expense, with roughly half of that expense expected to be incurred during Q4.

Finally, that takes to me to adjusted EBITDA margin, which, like adjusted gross margin, we are raising from our previous expectation.

Given the strong results we achieved during the third quarter, we are increasing our expectations from our previous guidance that adjusted EBITDA margin would be in the "low-30s", to our current expectation which now calls for second half of the year adjusted EBITDA margin to be in the "mid-30s".

As we look forward, our updated guidance for second half of fiscal 2022 adjusted EBITDA margin would imply a "low-30s" margin during Q4, with the expected sequential decline from Q3 to Q4 primarily driven by:

- Our fourth quarter adjusted gross margin which is expected to be in the "low-60s"

- And a sequential increase in operating expenses, primarily due to additional R&D expense, as well as additional expenses incurred associated with standing-up embecta as an independent company

In closing, embecta continues to be very well positioned to exit fiscal year 2022 with a strong financial profile as we complete our first six months as an independent company.

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

DEV:
Thank you, Jake.

Wrapping up our discussion on slide 10, you will see that our capital allocation priorities are set with the intention to make strategic investments to accelerate our long-term growth profile.

We expect to do this through commercial investments, the introduction of next-gen products, and M&A.

- First, we can continue to expand and penetrate through our core business. This includes e-commerce investments as well as educating people with diabetes and other stakeholders on the benefits of using a new device for every injection.
- Second, 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

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

Before we open up the line for Q&A, I would like to extend my thanks to the global embecta team for everything they have done and continue to do to serve people with diabetes while we stand up embecta as an independent company.