ConvaTec Q1 2018 Trading Update

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Paul Moraviec

Chief Executive Officer, ConvaTec

Good morning everyone. We have made a solid start to the year in Q1 and overall we are on track. I am satisfied with where we are as a business. We said back in February that 2018 would be a year of stabilisation, focused on clear commercial and operational objectives and this is what we have been executing on. We have made progress across the Group. With strong performances in two of our franchises, Infusion Devices and Continence & Critical Care, while the other two franchises reflected the impact of the supply constraints as expected. However, we have been making progress here as well and we are encouraged by good underlying demand across our franchises and our key brands.

Q1 2018 Key Points

We have made a solid start to the year and we are comfortable with the full-year guidance that we gave in February. At a Group level our organic revenue performance was in line with our expectations and clearly demonstrates the benefits of our diversified portfolio. Group revenue of $458.2m grew 3.7% on an organic basis. That is 7.5% on a constant currency basis including the revenue contribution of Woodbury and our recent J&R Medical acquisition, both in CCC. On a reported basis Group revenue grew 13.7% which includes the positive foreign exchange impact of 6pp.

Ostomy Care performance in the quarter reflects the supply constraints and consequent lost patients of last year, which we have talked about previously. I am however pleased with the underlying momentum we have maintained in this business especially in the US with our me+ programme and other direct-to-consumer initiatives. In advanced wound care the recovery of our lost accounts due to the supply constraints specifically in surgical cover dressing and our hydrocolloid business is progressing. However, we saw a strong demand in our core business for AQUACEL Foam and silver. In CCC, our Home Distribution Group is continuing to take market share in the US. In Infusion Devices we launched MiniMed Mio Advance with our partner Medtronic. This is our innovative new infusion device which you may recall we named Ulysses internally.

We are reaffirming our guidance for the full-year which we provided in February with revenue growth expected to be between 2.5% and 3% on an organic basis and adjusted EBIT margin to be between 24% and 25% for the full-year. We expect revenue to broadly reflect historical H1/H2 phasing and adjusted EBIT margin to have a significant H2 weighting as seen in prior years.

Franchise Results Overview

Moving to revenue performance by franchise, Advanced Wound Care grew 2.2% on an organic basis in the first quarter. Ostomy Care declined by 2.5%, CCC grew by 5.6% and Infusion Devices grew 16.3%. That adds up to 3.7% for the Group overall, as I mentioned.

Advanced Wound Care

Good growth in foam and silver, ongoing recovery of lost accounts

Moving into the franchise performance in more detail, in Advanced Wound Care we saw continuing growth from our AQUACEL family of dressings, as I mentioned. In particular foam and silver, specifically Ag+ in the UK, Germany, Italy and other EMEA markets. Avelle continues to grow, although we still expect the contribution to this franchise overall to be modest. As I outlined in February, we are addressing our post-acute performance in the US, better aligning our resources and focusing on account conversion while repositioning our foam offering. We have seen a positive customer response with early wins providing the encouragement of further investment.

We continued to rebuild momentum following last year's supply constraints and we are progressing plans to regain lost accounts in surgical cover dressing and our hydrocolloid dressing, DuoDERM. The strong underlying growth in our core brand provides us with confidence that we can continue to make progress in our wound franchise as the year progresses.

Ostomy Care

Positive me+ momentum, ongoing impact of supply constraints

In Ostomy Care revenue declined 2.5% in the first quarter as anticipated. You will recall that we signalled Q1 would be weaker than Q4 due to Q4 orders we took in Japan. We are making progress in fulfilling back orders on our mouldable products and we continue to stabilise and optimise our manufacturing and supply chain in Haina. We anticipate that Ostomy back orders overall will fall over the coming months and we therefore expect our Ostomy revenue performance will improve through the rest of 2018. We also continue to see good momentum in patient enrolment on the me+ DTC platform and in our Convex products launched last year.

Continence & Critical Care

Strong HDG performance

Continence & Critical Care delivered a strong performance in the first quarter growing at 5.6% on an organic basis. Our reported revenue for the quarter also includes $15m from Woodbury Holdings and $0.9m from our recent acquisition of J&R Medical. As you know, we also disposed of the Symbius Medical respiratory business on 1st March.

Home Distribution Group continues to grow faster than the overall US continence market as we leverage our reach, our extensive panel of insurers, our strong relationships with clinicians and our service levels to patients. We have now launched GentleCath Glide in eight markets, including the US, and are planning to launch in several additional markets in Q2. Although as we have previously indicated, revenues from outside of the US will be fairly modest in 2018.

Product rationalisation continued in Q1 reducing revenue by around 0.8pp. We are still targeting a 2018 launch for the first of our next gen catheters with clinical trials commencing soon.

Infusion Devices

Good underlying growth boosted by significant tailwinds

We saw good underlying growth in the insulin pump market but we also had the benefit of a significant inventory increase by one of our major customers as well as a customer voluntary product recall which started last year and finished in Q1. Along with a weaker first quarter in 2017 this created a significant tailwind which delivered a very strong 16.3% organic growth. We expect that for the full-year growth will be broadly in line with the insulin pump market.

A characteristic of the ID business is the quarter-on-quarter fluctuations and this significant Q1 inventory increase is expected to impact Q2.

In the quarter we launched MiniMed Mio Advance with our partner Medtronic to a very positive patient reception. We also continued to explore applications beyond insulin therapy with our neria guard infusion sets.

Commercial and Operational Objectives for 2018

Commercial

Let me recap the 2018 commercial and operational objectives which are highlighted in our February results announcement. As I mentioned, we are taking action to address our performance in the US post-acute channel in wound and this will drive improved growth in Advanced Wound Care as we move through 2018. Foam and silver delivered a strong performance in the quarter and revenues from Avelle continues to grow, although as previously indicated, revenues from Avelle will be modest in 2018. Our Ostomy strategy continues to progress with growth in our me+ platform and good momentum in our Convex products launch last year.

Operational

We are continuing with the stabilisation and optimisation of our manufacturing and supply chain in Haina reducing scrap rates and improving overall equipment effectiveness and productivity. We will continue with that optimisation to move towards and then beyond the efficiency levels that we saw at Greensboro before the transfer. We expect to deliver modest productivity improvements in 2018 gross margin offset by price erosion and other headwinds that we previously outlined.

We have developed plans for cost-out initiatives, focused on the five areas that we mentioned in February. Namely: sourcing, supply chain, manufacturing, footprint and simplicity. We continue to make progress validating the overall cost-out opportunity and we will give further guidance on the framework and size later this year. We have bolstered our Project Management office with new hires in the operations area such the new VP of Global Operations Engineering, who will take a key role in driving forward our productivity initiatives and continuous improvement.

Q1 2018 Summary

In summary the first quarter demonstrates a solid start to the year. At a Group level performance it was in line with our expectations. We saw strong performance from Infusion Devices and CCC. In Ostomy Care we are stabilising and optimising our manufacturing and supply chain in Haina and we expect that our Ostomy performance will improve through the rest of 2018. In Advanced Wound Care we remain confident that we can continue to make progress winning back lost accounts and we expect to deliver improved revenue growth in our wound franchise as we progress through the year. Finally, our guidance for the full-year 2018 is reaffirmed. With that brief overview of our first quarter results we are happy to take questions. As John mentioned, I am here with our CFO Frank Schulkes.

Q&A

Amy Walker (Peel Hunt): The first question is, you have obviously beaten the top end of your organic growth guidance for the full-year but you have maintained the full-year range today. Is that because of higher 2017 base as we move through the year or some conservatism on your part or perhaps a bit of both?

The second question is, could you quantify for us in dollar terms the positive impact in the first quarter of the customer inventory increase and the product recall effect in ID? Paul, I am not sure if I understood you correctly that you expect that to carry forward into Q2. If you can give us some indication of the quantity of that as well that would be helpful.

The last question is, your comments on the Avelle launch seemed consistently quite cautious to me. Why do you think the uptake has been a bit more muted than perhaps we would have expected so far? Is the longer life versus the incumbent product less compelling to medical practitioners than you had expected? What is the reason and what levers do you feel that you have to improve that?

Paul Moraviec: The first thing around the overall performance, if you look at the Infusion Device business the underlying that we still see for that business is around that 5% and so if you back out the inventory parts of that the other parts of our business are exactly where we expected them to be.

Frank Schulkes (Chief Financial Officer, ConvaTec): I think that is right. The underlying business is growing in line with the market which is at 5%. Q1 is an extraordinarily high quarter. We have seen this type of revenue volatility in the past as well so the full-year it evens out to market rates.

Paul Moraviec: As you point out Amy, Q2 will be lower of course and I think we will see some sort of offset there. It is always very difficult to judge exactly where that will be but obviously it will be a lower quarter and there will be some form of correction in there. Then on Avelle as we said before with Avelle this is our first entry into the NPWT marketplace and I think the key benefits of Avelle that we have seen with clinicians, nurses and patients has been extremely well received. The AQUACEL interface, the flexibility in terms of SKUs that we have for that product and the extended time that it runs for, all very, very well-received. We are working our way through market by market. I think that we will see that business growing and accelerating through this year. However, we are already off to a very good start in Q1. There has been a lot of learning for us in the company getting into this space. We have made those learnings, we are applying those learnings this year and we are starting to see the early signs that that is paying off. We are very committed to this space and expect it to be a major contributor in the coming years.

Amy Walker: On the Group guidance point about having coming in above the top-end and maintaining the range, I wanted to clarify, is that because you expect the comps to be a bit higher sequentially through the year?

Paul Moraviec: That is right. If you look at where we were in Q1 there will be an adjustment of Infusion in Q2 and then we obviously have comps in the second half. Broadly-speaking that is the way you should think about it.

Michael Jungling (Morgan Stanley): Firstly, on the geographic sales growth US seems to be consistently quite good but if I look at Europe and APAC it really is quite uninspiring and in fact grows very even and slight declines. What is preventing you from doing a better job in EMEA and in APAC?

Secondly, when it comes to Ostomy can you provide a bit more clarity what will drive the improvement in growth for the rest of the year and is a positive growth number organically a probability? Is it probable?

Question number two is on Continence Care. How sustainable is a 5% growth rate for the rest of the year?

Paul Moraviec: The first one on the US, the way that the regional numbers are calculated Michael, represents where the customers are. In the US you see a lot of the Infusion Device business reflected in that US number which obviously inflates the US and takes it away from that European number. Also, it is mainly because our CCC business is growing so strongly in the US market which gives us a very good growth in the US. With Europe the underlying is obviously in better shape than that although, as we have said before, we have seen some softness in some of the markets from a wound point of view. However, I will say that in Q1 we have seen a little pick-up there. Those are the key drivers there and obviously the other issue with Europe of course is that the back order situation that we had, supply constraints in Ostomy did affect Europe more than they did North America.

What was your next question Michael?

Michael Jungling: The next question was on Ostomy. What will drive the improvement for the rest of the year and is a positive growth number realistic for the year?

Paul Moraviec: Yes, I think so. Two things will drive that. In Q2 we are expecting a meaningful improvement in our open order recovery and then that will be pretty much the open order issue, back order issue resolved by the time we get to the middle of the year. As we go through into the second-half we will not be suffering from that. The other part of it is I am actually very encouraged by the underlying performance of the Ostomy business. If we think about new patient capture we are performing well there, particularly in the US. Also our market shares have held up pretty well in the European market regardless of the situation. When I look at my leading indicators for Ostomy I am actually very pleased with where we are considering the challenges we had last year. Those are the two drivers of that.

Michael Jungling: A positive growth number for the year is realistic and Q2 is the first part of that.

Paul Moraviec: Yes. It will take us time to build that, Michael. We obviously cannot give you specific numbers here but we are looking at probably the second-half before we see meaningful recovery. Think of a build going through the year but Q2 being better than Q1.

Frank Schulkes: I want to add something to that. If you look back also at our quarterly performance in 2017 you can see that Q2 was a very high year-over-year growth so the comp in the second quarter is going to be tougher than in the first quarter. As Paul said, we expect an improvement quarter-by-quarter but we are not saying that Ostomy will be positive already in the second quarter.

Michael Jungling: Then the Continence Care question, please? How sustainable is a 5% growth rate for the full-year?

Paul Moraviec: We are feeling very good about that number. Our customers, in particular Medtronic, are performing extremely well in the market. The market is still holding up extremely well. We have other activities going on within the Infusion business, particularly the launch of the Ulysses product which will be sold through Medtronic and in other indications.

Michael Jungling: I was asking about the Continence Care business. I was asking about Continence & Critical Care, not Infusion Devices. How sustainable is the 5% growth rate in Continence Care for the rest of the year?

Paul Moraviec: My apologies. With that business, again we feel very good about that. We are still continuing to gain market share and we are launching obviously our GentleCath Glide through that platform. We are feeling very confident about the sustained 5%.

Ian Douglas-Pennant (UBS): On Ostomy, could you quantify if you can the headwind that you had from manufacturing issues this quarter? I know there is an element of judgement in there but if you could have a guess that would be useful.

The second question is, given we saw in Q1 the lower margin businesses, by my estimates, have been relatively strong and the higher margin businesses are somewhat weaker, what does that imply for margins both in the first-half and for the full-year?

The last question, when you are buying Woodbury what was the competitive environment like? When you are bidding for that have you noticed an increase in competitor intensity when you are trying to roll up distributors?

Frank Schulkes: I think you were asking what the impact was of the Ostomy lost revenue given that we had the back order issues in 2017. Basically we see, what we also said in February, an impact of about 50-100bps in growth for the year in our business related to that patient loss and associated revenue loss.

At this moment if you look at the overall margin picture it is a little bit more complicated than just looking at the different franchises because of course we also have margin differences between the different brands within the franchise. Then there is also margin differences between the different countries where we sell all of products. Overall at this moment what I can see Ian is that we are basically in line with what we said in February and that is that we do not expect any significant impact from mix. It will move between, in my view a pretty narrow band, slightly positive or slightly negative. It is very tough at this stage after one quarter to comment on that for the rest of the year or for the second-half.

Paul Moraviec: The last one Ian, the M&A environment I would say the competitive intensity is high, as you would expect. I do not think that is any different to what it has been in the past. We track all the companies that we think make good sense to us and try to build relationships with them over a period of time. Obviously what we want to try to avoid is a competitive situation and we have not had that situation so far. I would say the competitive environment is high but we are able to navigate our way through that very successfully so far.

Frank Schulkes: Ian, to clarify my first answer, it is 50-100bps for the whole Group. That means that for the impact on the Ostomy franchise it is higher than that.

Ian Douglas-Pennant: Also, presumably even higher than that in Q1 given the impact is focused in Q1 and Q2.

Frank Schulkes: That is right.

Veronika Dubajova (Goldman Sachs): Thank you for taking my questions. My first one is a follow-up on Ostomy. I am trying to understand the various moving parts that you saw in the quarter. Clearly you had annualisation of some of the patient losses last year. I think you remarked, Paul that underlying base business performed well. You had some of the fulfilment of the back orders. If I were to normalise the growth can you help us understand what the performance was? It is maybe putting a little bit more colour around your answer that you gave to Ian. It would be helpful for us to have a better sense for what the underlying trend pattern is in the business.

Then my second question is, given where the first quarter has come in, has your degree of confidence in the full-year guidance that you have changed at all? In particular I am curious around margin.

Paul Moraviec: Yes, you are right in terms of the Ostomy business. Q1 was impacted by number one the patient loss, accelerated obviously a little in Q4 and obviously the fulfilment of the open orders which we are making good progress on but they still exist there. If you were to adjust for that our sense is that the underlying growth would be around that 2-3% range.

What was the second question, Veronika?

Veronika Dubajova: Your degree of confidence in the guidance for the full-year and whether that has changed at all versus where you were in February.

Paul Moraviec: No, we are still comfortable with that level of guidance. Q1 is exactly where we expected it to be in all of the franchises. I think we are where we expected to be.

Veronika Dubajova: Then a quick follow-up, Frank. You made a comment in the press release this morning about the phasing of profitability first-half versus second-half. Any further colour you can provide on that?

Frank Schulkes: Yes, historically the EBIT rate is significantly higher in this business in the second-half versus the first-half and that is really driven by a couple of things. As you know, we have revenue seasonality. The second-half revenue is higher than the first-half and then also what you typically see is that cost-out programmes and productivity programmes in any business are building throughout the year. Finally OPEX between the first-half and the second-half is not that different. That drives a significantly higher EBIT rate. For instance, in 2017 the difference between the first and the second half was around 500bps. That was in fact with all the challenges we faced in the second-half of 2017. If you were to adjust for that you probably would be anywhere between 500bps and 600bps lift and that is also very much in line with what we saw in 2016 which was around the 550bps mark. There is a significant lift and this is the reason. It is historically proven.

Question (Deutsche Bank): Just a clarification question on the Ostomy growth and the 2-3% underlying that you mentioned. Is that also adjusting for the distributor benefit from Japan? If not, what was the benefit from this in the Q4 2017 and what impact did that have on the Q1 2018 numbers? How will that move in the rest of the year?

Then on the second part, the back order I think at Q4 2017 you mentioned that would account for about 1% of the organic growth. Roughly what percentage of the back orders has been filled by the end of the March 2018 quarter?

Finally, one of your competitors is planning to launch a concave product which will be a new category in Ostomy. How do you think that would impact you and do you have any similar products in your pipeline that could come to the market in the near-term?

Paul Moraviec: I think the way to think about Ostomy is that the 2-3% is the underlying growth that we see in the Ostomy business if we adjust for the various things that we have just spoken about. We have not been specific about the Japan situation but I think that is the main soundbite to take away from this. If we adjust for the open orders and the patient loss we are around that 2-3%.

Frank Schulkes: If you look at the overall back order position and the improvement we see in the first 6-7 months of the year the minority has been improving in the first quarter and we see a much bigger reduction in the back order in the second quarter. The impact will be more pronounced in the second quarter versus first quarter.

Paul Moraviec: On the new products I think about this as every market continues to segment as it matures and companies like ourselves and our competitors will continue to launch products that fulfil specific needs or unmet needs in the marketplace. We have been doing exactly the same. The accordion flange product will be a perfect example of that for post-operative patients. Indeed, we will continue to develop our product portfolio and continue to look for segments and that is the way I think about it.

Question: What portion of the patients do you think will benefit from these products? Do you have a direct competitor product for this? Do you have a product that specifically addresses this need in your portfolio?

Paul Moraviec: We have similar products. Yes, we have similar products but I think this is a product that has identified a specific need in the marketplace. We do not have a direct but we have other products that obviously have been used for this indication. This is normal developments in a marketplace. You see it right across our businesses.

Question: What is that product that you have in your portfolio that would address this change in the market?

Paul Moraviec: The range of Convex products that we have launched last year.

Lisa Clive (Bernstein): First of all, could you give us an update on your plans for building out Continence business in Europe? Have you made much of a push into that market yet or are you waiting for the release of your next generation hydrophilic catheter before really trying to ramp up your presence in that geography?

A related question, given the success of 180 Medical in the US, are you looking to acquire catheter distribution or home care businesses in Europe to expand that strategy in other markets?

Lastly on the Avelle roll-out, what kind of clinical data do you have supporting the product? Is that an area that perhaps needs to see further R&D investment in order to really maximise the commercial impact? Also, if you could give an update on the US approval and launch for Avelle.

Paul Moraviec: On the Continence business we are still in the same position as we talked about in February in the sense that we have launched GentleCath Glide in Europe. Although that is a very small segment and so we are making some sales there. That is mostly a US product, as you know. The major opportunity for us remains European compact design products. That is exactly what we are doing and we would expect to be going into clinical trials late this summer. We will launch soon after. That is the plan at the moment.

The next question was around 180 Medical, is that right? What was the question?

Lisa Clive: Yes, really the success there and whether you would do something similar in Europe.

Paul Moraviec: We have to keep our eyes open for opportunities. Clearly we track a lot of different companies. I think that initially we will be using the footprint that we have in Europe, which provides us with a very good launch position. Then we will look at other opportunities as time goes on.

From an Avelle point of view we are still working with the FDA on the launch of that product and I would expect that we will be seeing that product into the marketplace late in Q3.

I think there may be one other small question there Lisa. Have I missed something?

Lisa Clive: Yes, just around clinical data.

Paul Moraviec: It is a great point and naturally it is a relatively young launch for us so we are collecting that data. You are absolutely right. We already have data and we are generating a lot more. We consider that to be a key part of the growth strategy.

Paul Cuddon (Numis): Could you elaborate on the expectations for gross margin for the half and the full-year?

Secondly, on the potential for infusion sets beyond diabetes and perhaps timing of when that could generate more material revenues?

Frank Schulkes: I will take the margin one. In February we mentioned that we expected a modest contribution from productivity cost-out as well as price erosion around the 1% mark. We said that the modest productivity contribution is really driven by cost-out programmes kicking in. That would be partially offset by elevated freight cost, some commodity pressure, higher depreciation and labour rate inflation. As I look at the business from my seat now here in May basically that is playing out as we expected so no change there from a guidance point of view. In terms of first-half/second-half I already mentioned that there is quite a significant change and lift in EBIT rate between the first-half and the second-half. Of course, there is also historically, and you can see that, a lift between the first-half and second-half in gross margin. Again, driven by the revenue seasonality higher in the second-half versus the first-half and the typical building of cost-out programmes throughout the year. Looking at the numbers here 2017 was something like 130bps increase from the first-half to the second-half and again that was facing a lot of the challenge in the second-half. If you adjust for that the historical lift is higher and in 2016 that was around 400bps. I would say we will see again a significant lift also there in gross margin and for the year, in line with what we guided towards in February.

Paul Moraviec: On the Infusion Device business the subcutaneous opportunity is very exciting and obviously we are putting resources behind that. We are in discussions with a number of large pharma companies, and that includes setting up clinical trials. We see this as a sizeable opportunity in the longer-term but I would emphasise that this is at the very early stages of development.

Michael Jungling: I have a couple of follow-up questions. When it comes to Ostomy I wanted to clarify whether the Q1 organic growth benefitted materially from filling back orders or not.

Secondly, on Continence this product rationalisation headwind of 80bps in Q1, does that headwind continue at the same rate for the rest of the year or does it ease?

Question number three is on the self-lubricating catheter that you mentioned you would be launching in the second half of this year. You just mentioned the word compact. I did not think that compact was an option because it was not in the patent from Coloplast. I thought the product that you are launching was a self-lubricative catheter only competing with Speedicath but not with Speedicath Compact. Can you please clarify that word compact?

Paul Moraviec: On Ostomy think about Q1 as some filling of open orders, making good progress there, but that being more than offset by lost patients due to the issues last year. That is the way to think about that one.

Frank Schulkes: On CCC 80bps rationalisation, at this moment I would say this is probably going to continue. I cannot specifically say it is going to be even every quarter but at this moment perhaps the best to say is that it is for sure over the next three quarters and then probably a little tail in the fourth quarter. In the end we are getting into very small differences here but it is not going to be only in the first six months of the year. It is going to be about a $3m impact for the year.

Paul Moraviec: On the last point I simply used that compact description as a category, as a smaller form factor category that exists within that catheter space, particularly relevant to the European space. Does that answer your question?

Michael Jungling: It does. Then on Ostomy for the rest of the year are we expecting that the back orders will come back through more strongly, let us call it in Q2, than the lost patients? Meaning that it will start to show up more in the second quarter. Would that be correct?

Frank Schulkes: As we said, the back order reduction in Q1 was pretty modest. We see an acceleration of that back order improvement in the second quarter. Then basically in the second-half we should be at normal levels of back order which you normally see in running a business. That means that in the second-half we are going to continue to gain patients back and that is going to be the focus and slowly build on top of that. Plus of course the comp in the second-half will be a little easier than specifically in the second quarter.

Paul Moraviec: Again, thank you everyone for joining the call this morning. With that we will draw it to a close. Our interim results are out on 2nd August. Of course, myself, John Crosse and Kirsty are on hand to answer any other questions in the meantime. However, thank you for joining and good morning.

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