ConvaTec Q3 Company Update (8am)

Monday, 16th October 2017

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Introduction

John Crosse

Vice President Investor Relations, ConvaTec

Opening remarks

Hi, good morning, everybody. It is John Crosse here, Head of IR. Just before I hand over to Paul, thank you for joining us at short notice. Just wanted to point out the forward-looking statement and regulatory information in our announcement this morning. Without further ado, I will hand over to Paul.

Q3 Trading Update

Paul Moraviec

Chief Executive, ConvaTec

Introduction

Thank you, John. Good morning, everyone. I would add my thanks to you all for joining us at short notice for our Q3 trading update. I am here today with our CFO, Nigel Clerkin; and our CFO designate, Frank Schulkes. As you know, Nigel will leave ConvaTec at the end of this month, and Frank will become CFO on 1st November.

Overview

In Q3, revenue growth increased 5.1% at constant currencies, or 3.3% on an organic basis. We continue to expand our portfolio across new products and new geographies. As you know, we recently entered the European market with GentleCath Glide, and we completed the acquisition of Woodbury Holdings on 1st September. However, I am disappointed to report that our performance in the third quarter was lower than expected. It was severely impacted by supply issues, which resulted from execution issues with our MIP programme. While seeing growing momentum, we also saw lower revenue contributions from new products. I will talk about these in detail in just a moment.

Q3 2017 key points

So, looking at the key numbers: Q3 revenue fell short of expectations, with organic revenue growth of 3.3%. This accelerated, as expected, from the first half, though was weaker than we anticipated, driven principally by supply issues in our Wound and Ostomy franchises, arising from the transfer of manufacturing lines from Greensboro in the US to Haina in the Dominican Republic. Advanced Wound Care grew 1.4%, while Ostomy Care declined by 1.8%, both on an organic basis. Both Continence & Critical Care and Infusion Devices delivered a strong performance, with 4.5% and 17.3% organic growth respectively in the quarter. However, overall, performance in Q3, combined with our current outlook for Q4, has led us to lower guidance on revenue and our margin improvement programme for the current financial year. Organic revenue growth is now expected to be in the 1–2% range. With regard to MIP, as a result of the supply issues we expect to lose the 40 basis points of benefit delivered by the MIP programme in the first half of this year. We also expect to lose the majority of the 90-basis-point benefit delivered in 2016.

Franchise results overview

Weaker than expected growth

Let me take you through the third-quarter results and guidance change in more detail. In Wound Care, organic revenue growth for Q3 was 1.4%. Fulfilment of the back orders we highlighted in the first half is ongoing, although we made less progress in the quarter than anticipated. Unfortunately, this has resulted in some loss of orders. We also continue to be negatively impacted by the changes earlier this year to French reimbursement. In Ostomy Care, revenue declined 1.8% in the third quarter, driven by supply disruptions following the transfer of the final manufacturing lines to Haina. This has led to an increase in back orders and some loss of orders. In Continence & Critical Care, revenue in the third quarter grew 4.5%. We continue to see a very strong performance from 180 Medical, as well as a reduced impact from our MIP programme. Finally, Infusion Devices: here, third-quarter revenue grew strongly at 17.3%; driven, as expected, by an increase in customer orders.

Advanced Wound Care

Ongoing weakness from continuing supply disruptions

In Advanced Wound Care, we grew 1.4% in Q3; lower than expected. In Q2, we told you about supply interruptions in our Haina plant. This was caused by delays we incurred transferring surgical cover dressings and DuoDERM manufacturing lines from the US. Our manufacturing lines took longer to ramp up and, as you know, there were delays in receiving certification from BSI, which we needed in order to sell products into Europe. We said that we would make progress in reducing back orders in Q3, but expected there would still be an adverse impact on revenue. We did make some progress in fulfilling back orders, but not as much as we had planned. This was mainly due to logistics, and was further impacted by the recent hurricanes. As a result, we lost some orders. We estimate that these supply issues reduced organic revenue growth by around 3.5 percentage points in the quarter. We continue to be impacted, as we have all year, by lower reimbursement rates in France, which reduced growth by approximately one percentage point.

We expected the contribution from new products to ramp up as we progressed through the year, but they did not grow as fast as we anticipated. We remain excited by the opportunity ahead for our new products; it has simply taken us a little longer to build the sales of these products in each market. As you know, the route to market differs country by country. We are building effective channels to market, and we are seeing growing momentum in our new product portfolio.

Ostomy Care

Supply constraints impact growth

Now to Ostomy: Ostomy revenue declined 1.8% on an organic basis in Q3, impacted by the complexities of transferring manufacturing lines to Haina. Now, earlier transfers of Ostomy lines were a success, and were up and running on time and at full capacity, in line with our plan of 60 days. We did not anticipate that the transfer of our last lines would take substantially longer to complete; Convex took 120 days to become fully operational. We are making progress with our mouldable lines, but these are taking even longer. This has led to a build-up of back orders in the quarter, which we are currently addressing. The back-order level of Convex products is already reducing, and we expect the situation to be resolved by year end. For mouldable products, we anticipate the back-order situation will continue through Q4 and into 2018, with a knock-on effect on back orders of mouldable products. Overall, these delays in Q3 had an impact of 3.5 percentage points on organic revenue growth.

Continence & Critical Care

180 Medical drives strong growth

Now, please turn to Continence & Critical Care. CCC delivered a good performance, with 7.5% underlying growth in organic revenue, adjusting for the three-percentage-point impact from product rationalisation under our MIP programme. We saw strong growth at 180 Medical, and GentleCath Glide is doing well in the US. We have just announced the launch of GentleCath Glide in Europe, although we will only start to see a revenue contribution in 2018. Our acquisition of Woodbury closed on 1st September, which contributed revenues of $4.5 million in Q3.

Infusion Devices

Good momentum

Turning to Infusion Devices: as expected, we saw an increase in customer orders in Q3, principally driven by new product launches. We also benefitted from a customer recall situation. We saw organic sales growth of 17.3%, and roughly 3% of that growth arose from the product recall.

MIP programme update

So, turning now to MIP. Our target was to deliver a cumulative 150 basis points over 2016 and 2017, and that was around half of our five-year target of 300 basis points by 2020. We delivered 40 basis points of gross margin benefit in the first six months of this year, and 90 basis points in 2016. However, given the supply problems I have outlined, we now do not expect any gross margin improvement in the current year, and it is likely that the majority of the 90 basis points of benefit delivered in 2016 will also be eroded. Half of the reduction in our revised MIP guidance is due to increased manufacturing costs and inefficiencies on legacy lines in Haina; the other half is a result of mix effects relating to the revenue outlook that we now have for the year.

Our focus now is on stabilising and resolving supply issues, and we are on track with that. Our issues in Wound have now been resolved, and we are working to address the Ostomy issues. Going forward, opportunities to realise further margin improvement remain. However, given the impacts we have experienced this year, we are reviewing the implications for 2018, and will give your further guidance at our preliminary results in 2018.

Guidance changes FY2017

So, to confirm the changes in our guidance: organic revenue growth is now expected to be in the 1–2% range as a result of the supply issues we have experienced, lower than anticipated contribution from new products and the loss of some orders. As I said for our margin improvement programme, the benefits delivered in the first half of this year are expected to be lost, along with the majority of the benefit delivered in 2016.

Q3 2017 summary

So, in summary, we saw an increase in Q3 organic revenue, but this was weaker than expected. Continuing momentum in ID and CCC was more than offset by supply issues and the loss of some orders in Ostomy and Wound. These impacted revenue and the delivery of the MIP programme, and as a result we revised guidance in 2017 for both revenue growth and margin.

Fundamentals remain

Whilst I do not in any way wish to play down the seriousness of the setbacks we have had, I believe we are on track to address them. The fundamentals of this business remain. We are well positioned in large, structurally growing chronic care markets, with strong brands and differentiated products with proven clinical performance. We are expanding our portfolio across products and geographies, and we have a strong and innovative R&D pipeline. With the resolution of the supply issues now well on track, and growing momentum in our new product portfolio, we are determined to drive performance, and opportunities to deliver margin improvement remain.

However, given the impacts we have experienced in the third quarter, we are reviewing the implications for growth and margins in 2018, and will provide further guidance at our preliminary results in 2018. We will now take any questions you have.

Q&A

Veronika Dubajova (Goldman Sachs): Good morning, gentlemen, and thank you for taking my questions. I will keep it to two. My first question is: thinking ahead to the 300 basis points of MIP targets by 2020, does that target still hold? How confident are you in your ability to execute on that? Maybe we can start that, and I will ask my second question after that.

Paul Moraviec: Thank you very much, Veronika. Clearly, we see the opportunity and potential for MIP has not changed; the scale of the opportunity that we have remains, but clearly what we need to do now – and I will be sitting down with Frank and with Donal in the coming weeks – is review the situation so that we can take a look at the timing of this issue. So, I think the quantum is something where we clearly see the same opportunity and potential, but clearly we need to look at the timing.

Veronika Dubajova: Very clear. Then my second question is on the lost orders that you have seen so far: can you help us understand how meaningful they were in the context of the disappointment in terms of revenues? How quickly do you think you will be able to regain these customers' trust? Is this a question of a quarter, or could this potentially derail some of the share momentum you have been seeing in both Wound Care and Ostomy beyond 2017?

Paul Moraviec: Yes, so it is always very difficult to estimate the impact of these situations. Part of that impact is the distraction that we experience in the market, when our salespeople are going to be distracted in looking after patients, and getting product from them, and moving product around. The benefit that we do have is that virtually all of our products are highly differentiated products, and they are preferred by patients; and so, whilst many of those patients will have to use a different product if they cannot get our products, many of them will return to us. However, there will be some losses in there as well.

So, I think there will be some loss of potential, but I would certainly expect that as we go through next year, that we are able to regain that, because the fundamental demand has not changed for our products. We really just need to work through these supply issues and the complications of that.

Veronika Dubajova: Okay, understood. Thanks, Paul. I will jump back into the queue.

Paul Moraviec: Thanks, Veronika.

Nick Keher (RBC): Hi guys, thank you very much for taking the question. I would really like to understand a bit better the decision to change guidance now, rather than at the interims, where you theoretically should have had good visibility of what was happening in the business, particularly within Haina, and the supply issues and fulfilment issues, the demand not being met. I will ask that one, and then I have a follow-up; thank you.

Paul Moraviec: Yes, it is a fair question, Nick. The reality here is that we did not have visibility of these issues at the time in August, when we were discussing first-half results. We did talk about Wound, but particularly on Ostomy: everything had, in fact, been going very smoothly in Ostomy, with all the lines. This is a major programme; we are talking a transfer of 30 lines and a substantial part of our business across to Haina. It is a major programme, and as I mentioned, everything had gone extremely well, certainly at the point that we spoke to you last, and it has really been the last couple of lines that have caused the major problems for us, which is our mouldable product. So, as I say, we did not have visibility at that point, and with machinery being transferred over long distances, things do go wrong, and unfortunately that is what has occurred here.

Nick Keher: Okay. Then just a follow-up on the AWM and Ostomy, the issues in terms of lost orders: I think you quantified it within AWM as about 350 basis points of growth; I am just trying to get the same figure within Ostomy as well, what you think a full-year impact would be from these lost orders?

Paul Moraviec: It is around 3.5 basis points, Nick.

Nick Keher: 3.5, okay. Is that within both Ostomy and AWM?

Nigel Clerkin: Yes, Nick, it was approximately the same in each.

Nick Keher: Okay, thank you.

Paul Moraviec: Thank you.

Ian Douglas-Pennant (UBS): Thanks for taking my questions. So, the first is one on Ostomy Care: could you give us a rough split between Convex, mouldable, and other within Ostomy? The reason I ask is, some rough maths on what you are expecting for Q4 would suggest potentially negative double-digit revenue growth. Clearly, I have got something wrong; I just want to work out what that is.

The second one is on the supply issues: is the issue here bad planning, or bad execution?

Paul Moraviec: Hi, Ian. So, the mouldable is around 10% of our sales, although it is a strong brand, as you know.

In terms of the programme itself, this is a very carefully planned programme, using very well respected external consultants working with our teams. I think, as you know as well, I hired probably the best operations leader in the medical devices world, Mike Sgrignari, to actually lead this programme as well; and it is a major programme. So, we have gone through that programme. Unfortunately, as you know, Mike passed away unexpectedly in March this year, and we have missed his leadership, there is no question about that.

That being said, it is a major programme; we have transferred somewhere around 30 lines into Haina, and most of that has gone extremely well. We have just had challenges more recently, particularly in Ostomy, where some of those last lines to go in have not run as successfully. So, these are things that are very much unforeseen, and it is very difficult to anticipate; certainly, the team expected that these last lines would run smoothly, but we have had the challenges.

Ian Douglas-Pennant: Okay, thank you.

Paul Moraviec: Thanks, Ian.

Paul Cuddon (Numis): Hi, guys. Thanks for taking my question. Only one: could you just remind me of the net debt covenants please, and how this statement might impact that? Thank you.

Nigel Clerkin: Paul, from a net debt perspective, our covenant ratio is north of five times, so there is not really any concern from that perspective. Net debt at the end of June, when we last reported, was three times, and we do not foresee any issue with covenants.

Paul Cuddon: Thank you.

Patrick Wood (Citi): Perfect, thank you for taking my questions. The first one, if I may, please: unless I am doing my maths wrong, it implies, similar to Ian's question, a very weak Q4. I am wondering: if some of these issues have begun to be resolved a little bit, why would you still expect an inflection downwards in Q4? That would be the first one.

Then the second one would be just in terms of incremental investment in the business: are you thinking about any kind of incremental marketing or SG&A-style costs going forward, in order to regain some of the lost customers over time? Is that something that we should be thinking about? Thank you.

Paul Moraviec: Yes, hi, Patrick. One of the challenges that a company faces when you do have a disruption like this is the impact that it has on the momentum in the business. It means that typically, salespeople are spending a lot of their time trying to get product into patients' hands, dealing with distributers, wholesalers, managers, etc.; and that disruption is something that does cause lost business, particularly in new business, and you lose momentum in the business. What we have tried to assess here is the impact of that going into Q4, so that is really the knock-on effect.

So, we do expect that we will have issues with supply of Convex through the rest of this year, and obviously, we also need to be making sure we fulfil all the backorders, and also build our safety stocks. So, we have combined all those thoughts together in order to put an accurate Q4 plan and full year together. So, those are the real reasons.

Sorry, what was your second question?

Patrick Wood: The second question was on incremental investment in marketing and things like that, in order to, let us say, placate those customers that are maybe having difficulty getting supply at the moment.

Paul Moraviec: Yes, I would not expect anything significant. We will take a look at that, and I think that as we start to look at reporting our guidance for 2018, we will be able to give you more information on that. But I would not expect meaningful or significant changes there.

Patrick Wood: Sure. Thank you very much.

Paul Moraviec: Thank you.

Michael Jungling (Morgan Stanley): Yes, good morning. I have two questions. My first question is on the US GPO contract: can you comment on the risk of losing your positions on some of those key contracts, and also whether there is any financial penalty?

The second question I have is: in relation to your 2018 guidance, what are the key uncertainties that you face today, meaning with respect to organic sales growth and also margins?

Paul Moraviec: On the US GPOs, we are not aware of any issues there at this point in time. Clearly, we are having discussions with distributors in the US about the situation, and we are managing that situation, but certainly, we are not aware of any financial impacts of that at the moment, Michael.

Sorry, what was the second question?

Michael Jungling: The second question was on the 2018 guidance, some sort of breakdown of what is causing the uncertainty. I know this may not be ideally what you would like, but if you look at manufacturing, is 50% of the uncertainty for fiscal year 2018 new products, or the lack of new product uptake; is it 20%? Is it staff execution of 10%? Some sort of guidance as to what is causing the uncertainty to giving guidance for 2018. That would be very useful, thank you.

Paul Moraviec: Yes, well, we have not actually put out the guidance for 2018, and the right thing for us to do at this point is for us to sit down and to understand the implications of this. As we work through the back orders, we will get a much better understanding of the situation for 2018. So, I think it is too early for us to talk about 2018.

What I will say is that, as I mentioned with MIP, I certainly see the opportunity and the potential for that programme. We have had a major setback here, there is no question about that, and it is up to us as a company now, and as a leadership team, to rebuild our plans, and then to start to deliver on these plans.

Also, from a commercial point of view, nothing changes in terms of the underlying demand for our products, and the attractiveness of those products. We just need to make sure we get through these back-order issues as quickly as we possibly can, so that we can focus our teams onto actual growth and market share gain.

Michael Jungling: Okay. I will ask a question slightly differently. In terms of the issue that we are facing today, in terms of supply and also poor uptake of new products, is the issue roughly 50/50, or is it 70/30 in favour of manufacturing? Just some sort of clarity as to how products, and also manufacturing supplies, have impacted your top-line growth.

Paul Moraviec: I think the root cause of all of this are the supply issues, and the knock-on effects that come from that. I think that is the way to think about this, Michael. As far as new products are concerned, we do have good traction in those new products; we just do not have the extent of traction that we had hoped for in the second half, and that is the reason why we have changed the guidance at this point.

Michael Jungling: Great, thank you.

Paul Moraviec: Thank you.

Veronika Dubajova: Just circling back on the full-year guidance for this year: I am trying to understand, what would be your expectations for Wound and Ostomy for the fourth quarter? Can you maybe elaborate on what you have assumed in that 1–2% guidance specifically for those two divisions, for either the full year or the fourth quarter? That would be helpful.

Paul Moraviec: Well, we do not give specific guidance, Veronika, franchise by franchise, but I think it suffices to say that the ID business and the CCC business are exactly on track with where we had expected them to be. I think Wound will obviously grow faster than Ostomy, but I would not want to give you any more detail than that at this point. A lot of this is going to depend on the fulfilment of the back orders, and overcoming the distractions that we have had.

Veronika Dubajova: Okay, so let me ask this slightly differently: if I look at the Ostomy issue, how much of the quarter was impacted by the issues with Convex and mouldable technology in Q3? Where are you with those manufacturing lines as far as today is concerned?

Paul Moraviec: Yes, so the bulk of the challenges that we saw in Q3 were down to the supply issues, Veronika.

Veronika Dubajova: What part of the quarter did those issues start? Was it July, August or September?

Paul Moraviec: The end of August is when we started to see the issues with the last lines going through.

Veronika Dubajova: Okay. Where are those lines today?

Paul Moraviec: So, the Convex line is now up and running, so that is okay, but we are still having challenges with the mouldable line, so that is not currently running at capacity. We expect that challenge to exist certainly through this year, and we think into the early part of 2018 as well.

Veronika Dubajova: Okay. Why are you not manufacturing these products in some of your other locations to offset the issues here?

Nigel Clerkin: Veronika, it is a capacity constraint issue, in essence. So, our core manufacturing for Ostomy is in the Dominican Republic and Slovakia, and all the lines that we have are operating at capacity. If we could make more, we would. So, it is not a question of just shifting production to spare capacity elsewhere; capacity is being utilised, again, until these lines are fully back to speed.

Veronika Dubajova: Okay. My final question is: you have detailed the impact on the gross margins, but anything in terms of your CapEx plans that changes as a result of what has happened, either as far as 2017 CapEx is concerned or more in the medium-term run rate?

Frank Schulkes: Veronika, on 2017, I do not think anything will change. 2018, in line with what Paul said, we need to re-evaluate the future here. As we said, the opportunity for MIP is still there. We need to look at timing, and there might be a CapEx component to that as well. We will report further out when we do the 2017 net earnings for early next year.

Veronika Dubajova: Okay. Thank you very much.

Yi-Dan Wang (Deutsche Bank): Okay, thank you very much. Just for follow-up on an earlier question, what proportion of your Ostomy revenue is Convex?

Then in terms of the issues that you have observed, I am just wondering: to me, relocating manufacturing should be quite straightforward; you make it in one place, you move it to another. If you could comment on what the key complexities were that caused this issue, and why these were not foreseen, and why you did not build up sufficient safety stock ahead of the relocation, that would be helpful. Thank you.

Paul Moraviec: Convex is actually a pretty small percentage – we are probably talking low single digits – in terms of the business.

I would disagree with you about the moving of plant. This is a major programme, and we are moving plant from the US into the Dominican Republic; when you move machinery, you have to sit it down, you have to run it, and you have to make sure you can get up to volume, you have to validate it, and there is a huge amount of work involved in doing that. Most of that work has gone extremely well; we have just had a couple of lines here where there have been mechanical issues. When you move a piece of plant, sometimes the motors or the drives will fail, because you have moved something over a very long distance, and you can have failure in circuit boards and things like that. So, there are a number of things that will happen in mechanical equipment when you move it. We have been able to mitigate virtually all of that, and we just had these last issues in terms of the move that have caused us these challenges.

Nigel Clerkin: Just to give you a sense of the scale, the Greensboro facility was about 25% of our total Ostomy capacity that we were moving to Haina, and about 10% of our Wound capacity. So, these were not small moves; this was a significant operation.

Paul Moraviec: It has to be said as well that, when you think about the overall MIP programme, this was the most difficult part; this was the part where there was the greatest risk. I think most of that has been mitigated, and has gone very smoothly, but some things have gone wrong, and this has created a huge setback for us this year, which we recognise.

Yi-Dan Wang: Okay. On the safety stock; why did you not build up enough safety stock ahead of the move?

Paul Moraviec: We did have safety stock in place. I will say, with mouldable, that our demand has been extremely high, which I guess is a good thing and a bad thing, obviously. When you look back on a programme like this, maybe that safety stock could have been a bit higher; I think we have to put our hands up on that one. However, those were the decisions made as this project was put together by some very experienced people.

Yi-Dan Wang: Okay. Then last question, on the amount of impact you have from back orders: how confident are you on those amounts? Meaning, as time passes, will those back orders become smaller in size if you are unable to fulfil them at the speed that your customers expect?

Paul Moraviec: Yes, they will. I mean, these things do happen, and backorders will be resolved. It is not just the back order; it is the level of disruption and the knock-on effect that you get from those as well, and that will take a while. This is why we have changed guidance, because these things will take a while until the end of the year to settle back down. The only issue we expect, going into 2018, is going to be the mouldable line, which we mentioned before.

Yi-Dan Wang: Okay. Sorry, I did say that was the last question, but you have brought on another one. So, given that you said you did not have enough visibility in August, how can you be confident that you have enough visibility to the first half of 2018 for full resolution of these issues in Ostomy?

Paul Moraviec: The main reason is because most of this has gone well, and we are looking at the last transfers that have caused the problem. So, we can isolate that to those lines, where we have an understanding of what is going on and we have the right fixes in place. It is just going to take us time to execute on that.

Yi-Dan Wang: Okay, thank you very much.

Paul Moraviec: Thank you.

Gunnar Romer (Deutsche Bank): Good morning, thanks for taking my questions; just two follow-ups. I think you mentioned that you have moved 20% of your Ostomy and 10% of your Wound capacity; just curious if you can help us understand how much of that capacity is now restricted as we speak, so at this point in time?

Then secondly, if you can comment on the OpEx ratio: I think you have upped it to 35% for the current year; how should we be thinking about that going forward? Is there one-timers included here? Are you still targeting to go back to the 33–34% you mentioned over the past? Just some colour around that, please.

Paul Moraviec: I think as far as the impact is concerned, we are not going to be able to get into the specific detail of that, Gunnar, unfortunately. It is difficult to break that out in detail, so I think that is where we are on that one.

Frank Schulkes: On OpEx, we are working toward the 35% number, so high end of the range we discussed before given of course, the changed revenue profile. We are looking at 2018, and we will have to re-evaluate what this means as a percentage of sales going forward which, as we said before on the MIP as well, we will report out on when we do our full-year earnings release in early 2018.

Ian Douglas-Pennant: Sorry, I just wanted to confirm: you just said you are working towards adjusted operating costs of around 35% of full-year revenue: are you explicitly saying that it will be more than that this year?

Frank Schulkes: No. As I said, it is 34–35%, which is the high end of the range which we discussed before, given a very different revenue profile.

Ian Douglas-Pennant: So, in 2017, you expect OpEx to be around 25% of full-year revenue?

Frank Schulkes: 35%

Ian Douglas-Pennant: Lovely, thank you.

Paul Moraviec: Okay. Well, thank you everyone, again, for calling in. I think that, just to summarise here from my point of view, and I know I speak for the team, we are conscious that this is a significant setback for the company and our plans. What we will say, or what I will say, is that the fundamentals of this business remain very strong, both from a top-line point of view but also in terms of the potential and opportunity we see for MIP. I will be sitting down with Frank and with Donal and the rest of the team to assess the situation, and our commitment is that we will drive the performance of this business and the execution of this business, take the learnings from what has happened here, and look forward to improved performance as we go through 2018. So, thank you very much for listening and for dialling in.

[END OF TRANSCRIPT]

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Introduction

John Crosse

Vice President Investor Relations, ConvaTec

Opening remarks

Good afternoon, everyone. Hopefully, you will have seen our Q3 trading update which we released this morning over here in London. I just wanted to draw your attention to some of the regulatory announcements and the forward-looking statement in that release, but without further ado I will now hand over to our Chief Executive, Paul Moraviec.

Q3 Trading Update

Paul Moraviec

Chief Executive, ConvaTec

Introduction

Thank you very much, John. So, good morning everybody, and thank you for joining us at short notice for our Q3 trading update. I am here today with our CFO, Nigel Clerkin; and our CFO designate, Frank Schulkes. As you know, Nigel will be leading ConvaTec at the end of this month and Frank will become the CFO on 1st November.

Overview

In Q3, revenue growth increased to 5.1% at constant currencies, or 3.3% on an organic basis. We continue to expand our portfolio across new products and new geographies. As you know, we have recently entered the European market with GentleCath Glide, and we completed the acquisition of Woodbury Holdings on 1st September. However, I am disappointed to report that our performance in the third quarter was lower than expected, and was severely impacted by supply issues which resulted in execution issues with our MIP programme. Whilst seeing growing momentum, we also saw lower revenue contribution from new products.

Q3 2017 key points

So, looking at the numbers: Q3 revenue fell short of expectations, with organic revenue growth of 3.3%. This accelerated, as expected, from the first half, though was weaker than we anticipated, driven principally by supply issues in our Wound and Ostomy franchises, arising from the transfer of manufacturing lines from Greensboro in the US to Haina in the Dominican Republic. Advanced Wound Care grew 1.4%, while Ostomy Care declined by 1.8%, both on an organic basis. Both Continence & Critical Care and Infusion Devices delivered a strong performance, with 4.5% and 17.3% organic growth respectively in the quarter. However, overall, performance in Q3 combined with our current outlook for Q4 has led us to lower guidance on revenue and our margin improvement programme for the current financial year. Organic revenue growth is now expected to be in the 1–2% range. With regard to MIP, as a result of the supply issues, we expect to lose the 40 basis points of benefit delivered by our MIP programme in the first half of this year. We also expect to lose the majority of the 90-basis-point benefit delivered in 2016.

Franchise results overview

Weaker than expected growth

Let me take you through the third-quarter results in guidance change in more detail. In Wound Care, organic revenue growth for Q3 was 1.4%. Fulfilment of the back orders we highlighted in the first half is ongoing, although we made less progress in the quarter than we anticipated. Unfortunately, this has resulted in some loss of orders. We also continued to be negatively impacted by the changes earlier this year to French reimbursement. In Ostomy Care, revenue declined 1.8% in the third quarter, driven by supply disruptions following the transfer of the final manufacturing lines to Haina. This has led to an increase in back orders and some loss of orders. In Continence & Critical Care, revenue in the third quarter grew 4.5%. We continue to see a very strong performance from 180 Medical, as well as a reduced impact from our MIP programme. Finally, Infusion Devices: here, third-quarter revenue grew strongly at 17.3%, driven as expected by an increase in customer orders.

Advanced Wound Care

Ongoing weakness from continuing supply disruptions

In Advanced Wound Care, we grew 1.4% in Q3; lower than expected. In Q2, we told you about supply interruptions in our Haina plant; this was caused by delays we encountered transferring surgical cover dressings and DuoDERM manufacturing lines from the US. Our manufacturing lines took longer to ramp up and, as you know, there were delays in receiving certification from BSI, which we needed in order to sell our products into Europe. We said that we would make progress on reducing back orders in Q3, but expected that there would still be an adverse impact on revenue. We did make some progress in fulfilling back orders, but not as much as we had planned, and this was mainly due to logistics and was further impacted by the recent hurricanes, and as a result we lost some orders. We estimate these supply issues reduced organic revenue growth by around 3.5 percentage points in the quarter. We continue to be impacted, as we have been all year, by lower reimbursement rates in France.

We expected the contribution from new products to ramp as we progressed through the year, but they have not grown as fast as we anticipated. We remain excited by the opportunity ahead for our new products; it has simply taken us a little longer to build the sales in these products in each market. As you know, the route to market differs country by country, and we are building effective channels to market and are also seeing growing momentum in our new product portfolio.

Ostomy Care

Supply constraints impact growth

Now to Ostomy: Ostomy revenue declined 1.8% on an organic basis in Q3, impacted by the complexities of transferring manufacturing lines to Haina. Our earlier transfers in Ostomy lines were a success, and were up and running on time and at full capacity, and in line with our planned 60 days. We did not anticipate the transfer of our last lines would take substantially longer to complete; Convex took 120 days to become fully operational. We are making progress with our mouldable lines, but these are taking even longer. This has led to a build-up of back orders in the quarter, which we are currently addressing. The back-order level of Convex products is already reducing, and we expect the situation to be resolved by the year end. For mouldable products, we anticipate the back-order situation will continue throughout Q4 and into 2018, with a knock-on effect on back orders of mouldable products. Overall, these delays in Q3 had an impact of 3.5 percentage points on organic revenue growth.

Continence & Critical Care

180 Medical drives strong growth

Now please turn to Continence & Critical Care. CCC delivered a good performance, with 7.5% underlying growth in organic revenue, adjusting for the three-percentage-point impact from product rationalisation under our MIP programme. We saw strong growth at 180 Medical, and GentleCath Glide is doing well in the US. We have just announced the launch of GentleCath Glide in Europe, although we will only start to see a revenue contribution in 2018. Our acquisition of Woodbury closed on 1st September, which contributed revenue of $4.5 million in Q3.

Infusion Devices

Good momentum

Turning to Infusion Devices. As expected, we saw an increase in customer orders in Q3, principally driven by new product launches. We also benefited from a customer recall situation. We saw organic sales growth of 17.3%, and roughly 3% of that growth arose from the product recall.

MIP programme update

So, now turning to MIP. Our target was to deliver a cumulative 150 basis points over 2016 and 2017, and that was around half of our five-year target of 300 basis points by 2020. We delivered 40 basis points of gross margin benefit in the first six months of this year, and 90 basis points in 2016. However, given the supply problems I have outlined, we now do not expect any gross margin improvement in the current year, and it is likely that the majority of the 90 basis points of benefit delivered in 2016 will also be eroded. Half of the reduction in our revised MIP guidance is due to increased manufacturing costs and inefficiencies on legacy lies in Haina, and the other half is a result of mix effects relating to the revenue outlook we now have for the year. Our focus now is on stabilising and resolving supply issues, and we are on track with that. Our issues in Wound have now been resolved, and we are now working to address the Ostomy issues. Going forward, opportunities to realise further margin improvement remain. However, given the impacts we have experienced this year, we are reviewing the implications for 2018 and will give you further guidance at our preliminary results in 2018.

Guidance changes FY2017

So, to confirm the changes to guidance: organic revenue growth is now expected to be in the 1–2% range, as a result of the supply issues we have experienced, lower than anticipated contribution from new products and the loss of some orders. As I said for our MIP programme, the benefits derived in the first half of this year are expected to be lost, along with the majority of the benefit delivered in 2016.

Q3 2017 summary

So, in summary, we saw an increase in Q3 organic revenue but this was weaker than expected. Continuing momentum in ID and CCC was more than offset by supply issues and the loss of some orders in Ostomy and Wound. These impacted revenue and the delivery of the MIP programme, and as a result we revised guidance for 2017 for both revenue growth and margin.

Fundamentals remain

Whilst we do not in any way wish to play down the seriousness of the setbacks we have had, I believe we are on track to address them. The fundamentals of this business remain. We are well positioned in large, structurally growing chronic care markets, with strong brands and differentiated products, with proven clinical performance. We are expanding our portfolio across products and geographies, and we have a strong and innovative R&D pipeline. With the resolution of the supply issues now well on track, and growing momentum in our new product portfolio, we are determined to drive performance, and opportunities to deliver margin improvement remain. However, given the impacts we have experienced in the third quarter, we are reviewing the implications for growth and margins in 2018, and will provide further guidance on this at our preliminary results in 2018. We will now take questions.

Q&A

Veronika Dubajova (Goldman Sachs): Thank you, gentlemen, for taking my questions. I have a couple of detailed ones, if that is okay? I am just trying to understand exactly what happened in Ostomy. I think you said this morning on the call that the impact was really largely isolated to September, and given that the business declined about 2% for the quarter, that would imply that September revenues were down almost 10%. So, I am trying to reconcile that with the fact that Convex and mouldable are only about 15% of your revenues; does this mean you were effectively shipping almost no product in the month of September? Or can you help us put those numbers into context, just so that we understand how the quarter progressed?

Paul Moraviec: Yes, hi Veronika. So, the issues that we experienced actually started in August, in the later part of August, and then spread into September. The way to think about this is that whilst mouldable was the main issue that we had, we did have issues with the Convex as well which are now resolved. The challenge that you always have when you go into a back-order situation is the level of disruption that this causes in the marketplace, and with our salespeople then spending all of their time trying to resolve these types of issues as opposed to driving demand on a regular basis. So, it really is the combination of all of these factors that come together to come up to the numbers that we reported.

Veronika Dubajova: Okay. So, can you maybe, Paul, confirm: did you ship any product in the month of September for either mouldable or Convex?

Paul Moraviec: We did ship product, yes.

Veronika Dubajova: Okay. Then my second question is a bigger-picture question. Obviously, you have two quarters behind you where things in the MIP have not gone exactly to plan; can you maybe talk about, as a management team and you particularly as CEO, how you are going to be approaching MIP differently from here? Are there changes you need to make, either to the execution of it or to just how closely you are paying attention to it?

Paul Moraviec: Yes, okay. The first thing, Veronika, is I think we need to put this programme into context. We have transferred over 30 lines into Haina; it is a huge project representing close to 30% of our business, in actual fact. So, this is a big deal, and most of this has gone extremely well; we have had some issues with Wound which we resolved, but we came under pretty severe pressure at the end of the quarter to process those orders, and then obviously we were impacted by hurricanes and logistics issues in getting orders through. In Ostomy, everything has gone actually extremely well, and it is really just those two lines, the last lines that went in, which are more complex machinery and slightly older machinery that have caused the problems. So, when you are transferring this amount of product, or this number of lines, in some respects to have this amount of challenge here is – it is not understandable, it is not acceptable of course, but the point is that most of this has gone well and we are looking at just two lines that have caused the problems here. So, my point really is that this is a temporary setback in an overall programme, and probably the most difficult part of the programme.

In terms of what we would do differently and what the learnings are from this: I think if we go back to the beginning of the programme, this is a programme that was put together by an external consultant, world class, together with the management team. We then hired one of the best executives in the medical device industry to lead it, Mike Sgrignari, and as I think you all know, Mike Sgrignari unfortunately passed away unexpectedly in March, and so we did miss Mike's leadership there; there is no question about that. As we have gone through this programme, Nigel and I have sat on a steering committee where we have been reviewing information, and I think that most of the time we have understood exactly where we are, and it is really just the most recent situation at the end of August where we have had these issues.

The other thing I would say is that Frank and I, soon after Frank joined, we both went to Haina ourselves to see it for ourselves, and we visited every single machine, and at that point everything was running very smoothly. It is really just post that where we have started to get into some challenges with the Ostomy line. So, I really do see this as a temporary step down. I am not making excuses, effectively; these things should not happen, and we see this as a significant setback for us, but these things will get back on track very quickly.

I guess the other key part of this is that three weeks ago we hired Donal Balfe, who actually came from the same stable as Mike Sgrignari. What Donal has been doing is running a considerable number of plants for both Covidien and Medtronic, and it is very normal for Donal to have been taking on new plants on a regular basis throughout his career, often plants that have had some problems and sorting them out. So, he is a deeply experienced executive; we have already been impressed at the speed at which he is getting into the issues and visiting the plants; he is in Haina as we speak today. So, I fully expect that we will get through this setback, which means we can then get back to realising the opportunity and the potential that we still believe the MIP programme has.

Veronika Dubajova: Okay. This might be a better question for Frank, I think, as an incoming CFO, but it seems to me that we have now had two quarters in a row where something surprised you at the very end of the quarter. Frank, are you comfortable with the internal controls in the organisation, and is the way that you think about setting guidance different from Nigel?

Frank Schulkes: I think the position we are in is caused by some very extraordinary factors here, so I think we have to take that into account. To give you perhaps an idea of how we got to the 1–2% guidance for the rest of the year, to give you a little bit of an insight what we have done to get there: we have had very detailed reviews with all the sales teams, starting really at the underlying run rate growth rate with their key customers. Then we went through the impact of the back orders, that is on top of the standard orders on hold. Also, a detailed estimation of what they think we are losing from an orders point of view, but at the same time also, what we could gain back. Connect that to the supply, so make sure that we are connecting the dots there, and then of course factor in seasonality. Then we have handicapped that and stress-tested that, and that is basically how we got to the 1–2%, and I feel very comfortable with that guidance. So, very detailed. Again, as I started, I think the situation that we are in is very extraordinary, so I do not think it has anything to do with lack of internal controls.

Veronika Dubajova: Terrific, thank you guys.

Paul Moraviec: Thanks, Veronika.

Michael Jungling (Morgan Stanley): Hi, I have two questions. Firstly: when the IPO process happened, as part of a slide deck we saw a second round of cost improvement programmes to be considered in 2017; can you talk about whether that programme of a second round of cost-cutting or efficiency programmes is still happening, and whether that is a reliable source of earnings contributions in fiscal year 2018? Then I will ask the second question in a second.

Paul Moraviec: Yeah, so there is a second programme, Michael, and part of that programme has in fact been started, but the bulk of that programme has not yet started. As Frank now transitions into his role, he will be looking at that and together we will be deciding at what point we actually implement that. However, that is a pretty carefully prepared programme; as I say, part of it started, part of it is still an opportunity for us.

Michael Jungling: Okay. When you give guidance for 2018, will this programme be part of the guidance? I am not asking about the specific number, but conceptually, is that part of the restructuring programme going to be meaningful for your guidance in fiscal year 2018?

Paul Moraviec: I think at this point it is too early to say, to be perfectly honest, Michael. It is possible that it is included, but it is possible that we talk about this further as we go through the year. However, at this point in time I would say it is a little too early, and I think we need to give Frank time to get into his role now, and then together with the rest of the team we will be reviewing that and moving as quickly as we can on all possible initiatives.

Michael Jungling: Okay, great. The second question is about organic sales growth. As part of the IPO process there was discussion surrounding an acceleration in organic growth, and there were many indications as to why that would be possible. If this is predominantly a slowdown in organic growth because of production challenges, would you suggest that for, let us say, 2018, keeping everything constant, the organic sales growth profile could still look more compelling in the future than it has for ConvaTec in the past, meaning in the last five years?

Paul Moraviec: Yes, I think all of the basics and the fundamentals of the business, as we described it in the IPO, remain exactly the same today. There is no question that this setback has impacted us heavily this year, and we are working fast and diligently and we are totally committed to get on top of this, and the bulk of this will be on top of by the time we finish this year. Then it is for us to get back on track, both with the MIP but also in the top-line growth. So, I do not think the fundamentals have changed here at all, Michael.

Michael Jungling: Alright. So, the final question then on 2018 is: if this is merely or largely or predominantly a function of production challenges as a result of what you have highlighted, there should be no good reason why in fiscal year 2018, there should be a deviation from your guided mid-term organic growth ambition. Does that make sense? Is that something that we can rely on?

Paul Moraviec: I can understand your logic. I think that you need to give us that little bit of time to see how this current supply situation is resolved over the coming months, and then we will put the guidance together for 2018. I think the other thing is that we have already stated that there will be an issue with mouldable for the rest of this year and likely into 2018, so we would need to build that into our thinking as well.

Michael Jungling: Okay, thank you.

Paul Moraviec: Okay, well thank you everybody, for dialling in. I think from a management perspective, we have seen this as a major setback and we are committed to resolving this as quickly as possible. We have everybody working very, very hard and long hours to make sure we get on top of things. I think most importantly is we see the fundamentals of ConvaTec being unchanged, both from a top-line opportunity in terms of our markets and the health of those markets, but also the demand and the attractiveness of our products and the demand for those products. Also from MIP point of view, from a quantitative point of view, we clearly see the opportunity and potential as being the same, and we will aggressively pursue that. The thing we just need a bit of time on here is to make sure that we assess the timing so that when we come back with 2018 guidance, we can give some precision to that timing. I think with that said, I will thank you all for dialling in.

[END OF TRANSCRIPT]