# ConvaTec Q3 Trading Update

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# Introduction

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**Welcome**

Good morning, everyone. Thanks for joining this Q3 Trading Update Call. I hope you have all had an opportunity to read the release. But before I open it up to questions, I would just make some opening remarks about the performance during the period and the outlook.

**Operational Highlights**

Our Q3 trading was in line with expectations and we continued to drive good momentum in the business. As well as achieving a positive operating performance during Q3, we made further strategic progress, including the disposal of HSG's incontinence activities, which were considered non-core.

During the period, we also signed an agreement to acquire Patient Care Medical, a quality service provider in the US that focuses on marketing to existing catheter users. This transaction, which is due to complete in December, is highly complementary to ConvaTec, as it enables us to leverage the 180 Medical infrastructure, while accelerating HSG's direct-to-consumer digital marketing efforts. The revenues on Patient Care Medical are expected to broadly offset the disposed non-core incontinence revenues.

During the period, we also introduced a new and consistent product development and launch process to advance our new product pipeline. This end-to-end process governs our actions and milestones from ideation through development to scale-up and finally approval and launch. It includes a suite of online tools to help with the entire workflow process along with metrics and milestones.

In keeping with this new process, we conducted investment development and scale-up gate reviews for new products such as MioAdvance Extended Wear Infusion Sets and the GentleCath Air male catheters, both of which we are planning to launch in 2022.

As you may know, we have moved the regulatory to report to the head of technology and innovation. And during the period, we have continued to improve our processes within the regulatory function. To improve the effectiveness and robustness of the MDR implementation and to use our resources most efficiently, we have proactively chosen to leverage certain existing MDD CE marks until their expiry in 2023.

And as a consequence, there will be approximately 8 million of MDR costs in 2022. We are continuing to make progress with key initiatives such as new and future digital marketing interventions to further increase and improve our interactions with healthcare professionals and customers.

We are also progressing plans to expand our Global Business Services centre beyond finance to include HR and IT in 2022. Another achievement during Q3 was ConvaTec's inaugural issuance of $500 million of unsecured notes at 3.875% on an 8 year term, which strengthens our balance sheet, diversifies our sources and extends our debt maturity profile by approximately two years to 4.3 years. The impact will be an extra $5 million of interest in 2021, given the higher interest rate and the write-off of the unamortized bank fee, plus roughly $9 million to $10 million of incremental finance expense in 2022.

**Financial Highlights**

Moving back to the financials for the quarter. Revenues rose 2.7% on a constant currency basis, and if we remove the incremental revenues from Cure during the period and adjust the for the disposal of the US skincare business, which last year contributed about $7 million in Q3 2020, then revenue rose 2.2% on an organic basis.

This relative slowdown in growth from the second quarter was anticipated, given the profile of the COVID impact in Advanced Wound Care last year, and a particularly tough prior year comparatives in Q3 2020 for Infusion Care and Critical Care.

**Advanced Would Care**

So let me unpick it slightly, starting with Advanced Wound Care. We saw a strong growth in Wound with revenues up 5.3% after adjusting for the disposal of skincare products. This was a slower rate than the second quarter, given the relatively tougher comparatives in the second half last year. We showed another quarter of strong growth in Latin America and Asia Pacific, with the exception of Japan, which was impacted by lockdown.

In Europe, we saw a good growth in most countries, offset primarily by declines in France following the reimbursement cut, as already disclosed. And in the US, we continue to experience good growth.

If we try to adjust for one-offs, notably phasing and COVID, we estimate that growth on an underlying basis was around 4%. Our Q4 growth expectations are more moderate than the third quarter, reflecting the continuing uncertainties relating to COVID and some potential phasing of fulfilment of orders.

**Ostomy Care**

Moving onto Ostomy Care. We delivered 1.6% organic growth in the third quarter. The business experienced continued strong growth in our global emerging markets, except Japan, Australia, New Zealand, which declined, given lockdowns in place during the quarter. This growth was largely offset by rationalisation and pressure in some established markets.

On an underlying basis, growth remained in the low single digits. And given the expected tapering of government funding in certain emerging markets, coupled with the second phase of rationalisation, Q4 results are likely to show some softness against last year’s relatively robust fourth quarter.

**Continence & Critical Care**

In Continence and Critical Care, revenues increased by 9.2% on a constant currency basis. And if we remove Cure Medical and adjust for the non-core incontinence disposal, the revenues rose 1.3% on an organic basis. This was primarily driven by robust performance in Continence, up nearly 3%, offset by an expected decline in Critical Care as we lap a period of very strong performance last year. Nonetheless, Critical Care sales were slightly better than anticipated.

Now looking forward, we continue to expect moderate growth in Continence Care. And in Critical Care, we anticipate a year-on-year decline versus the fourth quarter last year.

**Infusion Care**

Infusion Care declined 1.4% on an organic basis, reflecting the tough year-on-year comparatives. This performance was slightly better than anticipated, reflecting the phasing of orders and we expect a strong pickup in growth in Q4, given order patterns and the relatively easy Q4 comparatives.

**Guidance**

With respect to our 2021 guidance, we now expect to deliver organic growth towards the upper end of our revenue guidance of between 3.5% and 5%. Our constant currency margin guidance of 18-19% remains unchanged, although the FX headwind has reduced slightly to 60 basis points from 90 basis points. So the published EBIT margin is expected to be between 17.4% and 18.4%.

With that, I would like to open this call up to questions. Like last time, to ensure everyone gets a chance to pose their questions, please can I ask that initially everyone ask just one question. If towards the end of the call you still have an additional question, please press star one.

With that, I would like to hand it over to operator. Thank you very much.

## Q&A

**Patrick Wood (Bank of America):** I am just curious if you could give us any more colour just around the edges on cost inflation and the supply chain, just where you guys are seeing at the moment because we get a lot of conflicting feedback as you can imagine from a lot of the other companies we cover. So I am just curious any commentary you would add there would be really helpful.

**Frank Schulkes:** Sure. So in terms of supply chain, we communicated after our first half results that we expected the input prices to go up in materials as well as in freight. And that would be an impact on our EBIT in the second half of about 100 to 150 basis points. And that is very much the case. So we clearly see those higher input prices in materials specifically resin, PVCs, all the derivatives including the increases in container costs to increase. Sea containers are up, as you know, pretty significantly. So within that 100 and 150 basis points for the second half, that is very much what we experienced.

Second, in terms of supply chain challenges, yes, we see delays in some of the shipping lanes and overall supplies. But it is manageable. Our supply chain teams are doing an absolutely terrific job dealing with those challenges. And I think that the business is performing well. We are managing through the issues here and we are working with the freight forwarders, with our vendors on prioritisation, and in some cases, rebalancing, so basically make the impact as minimal as possible.

We expect, in Q4, some headwinds related to that, but again, as I said, it is very manageable. I hope that helps.

**Hassan Al-Wakeel (Barclays):** So very quickly, firstly on the top line, and congrats on a very strong nine months performance of 5.4%. As comps ease into Q4, particularly in Infusion Care, why do you think the business should slow as implied by your guidance and where could this be more conservative to your mind? And if I can just quickly follow-up on margins. Given you now expect the top end of revenue growth guidance, could you see margins in the upper end of the range? And any colour here would be helpful.

**Frank Schulkes:** Okay. Yeah, so to understand Q4, I think it makes sense to just click through some of the different product categories business units here. So if we think about Q4 in Wound, first, we see a little tougher comps. Last year we saw a pickup from Q3 to Q4. As we said, Q3 benefited from some order phasing coming from Q4, so that is a small headwind for the business in the fourth quarter.

And then, as I just mentioned, with the supply challenges, it is manageable but we expect a little bit more headwind in Q4 in Wound and basically all the different product lines. And of course, we will continue to have the impact of the French price cut but that was very similar. So therefore, we believe that Q4 in Wound will be softer than it was in the third quarter.

Looking at Ostomy Care, low-single digits underlying growth per quarter. If you look at last year on Q3 to Q4, there was a pretty significant step-up impact of about $10 million. So that comparative will be tougher. And we are starting the rationalisation waves too in the fourth quarter, which will have an impact versus Q3, so it will basically drive the overall revenue growth down.

Last point I want to make here is that we have seen terrific growth in the emerging markets, of course, because of great commercial execution and a lot of great other interventions. However, also a little help in the market by government programmes during COVID. We believe that those government programmes are starting to taper off and specifically the Ostomy Care business, and to a lesser extent, the Wound business benefited from that.

So therefore, the Ostomy Care growth will be weaker than in fact we have seen in the third quarter. And Crit Care finally is a variable was low-single-digit negative in Q3 and we expect with continuation of vaccination programmes that in fact that decline will be much pronounced in the fourth quarter. So if you all add that up, you basically get to a fourth quarter growth that is going to be, for several business units, so much softer.

**Hassan Al-Wakeel:** And on Infusion Care within that, given the improvement?

**Frank Schulkes:** Yeah. The best way to look at Infusion Care in terms of growth is maybe looking at a six or 12 months rolling average. And if you do that, you in fact see that the business is growing at higher single-digit range. So we expect a good growth of Infusion Care, a good performance in fourth quarter. Sorry, I missed that.

In terms of margins, listen, on one side indeed we are, at this moment, from a top line point of view, moving towards the upper end of the range. At the same time, there are a lot of variables in the equation here, including, of course, inflation that we talked about. So I do not want to point at this moment to a specific area within that 18% to 19% EBIT margin in constant currency and we feel comfortable with that 18% to 19%.

**Paul Cuddon (Numis Securities):** We have talked about the challenges on supply and freight. I am just wondering to what extent your customers are changing their stocking intentions with the general uncertainties continuing through Q4?

**Frank Schulkes:** Yeah, we have not really seen a lot of stocking activity. I think the challenges are global in all sectors. And as I said, we are managing to that trying to prioritise as much as possible rebalancing with one goal that is to make sure that all of our patients and customers are getting the products they need. But we have not seen any specific additional stocking activities. There is always going to be some stocking and destocking in this business, as you know, but nothing more than I've seen before.

**Graham Doyle (UBS):** Just one on pricing. So obviously you have got headwinds from inflation and supply chain cost pressures. But could you give us a flavour in terms of your flexibility on pricing over the next six to 12 months? And also do you expect the environment more generally to go from a price pressured environment, as you have seen past few years, to maybe inflationary environment where you have the ability to pass some of that cost increase on to your customers?

**Frank Schulkes:** Yes. So if we think about pricing and inflationary pressures here, I would say most of our markets are really reimbursement markets. So the opportunity to pass on inflation in terms of price is pretty limited, given that we see this inflation hike in 2021, nobody is going to change their reimbursements because of that. So it is relatively limited.

Now, we have certain contracts with distributors and these contracts are indexed. So where possible, we are executing the indexations. However, we got to be smart, of course, about this because in the end, the end price is not changing. And that means that if we would raise prices, distributors' margin would get squeezed. So we are smart about this because we do not want to end up in a position where the distributors will have to favour a lot of OEM and we are ending losing market share. But wherever possible, we do that.

More importantly, I would say that typically in our industry, we see a 1-2% price erosion on med-tech I have to say. ConvaTec has been experiencing historically about a 1% price erosion. And as part of the transformation, we invested in a pricing COE. With that pricing COE, we have improved overall pricing strategies. We have created much more visibility around pricing. We have done better training and there is more discipline around pricing. And therefore, in the last 18 months, in fact, we have been able to get that price erosion below 1% closer to 0.5% more structurally.

So that is a great achievement by the pricing COE. So if I think then about the longer term, it is very hard to forecast what governments are going to do. I do not think it is going to have an impact on reimbursement. In terms of tenders, there might be some impact in the future.

**Lisa Clive (Bernstein):** Just a structural question about your distributor business in the US, 180 Medical, which was a real success in the continence market. I recall a while back I heard there were plans to move it into Ostomy or maybe you already have. I was just wondering whether that is a growth opportunity for the business in the US and if you have in fact moved in that direction where you are in the process?

**Frank Schulkes:** Okay. So yes, the HSG business historically has been, of course, very successful and will be very successful going forward in the Continence area. It is a great model with high net promoter scores and executing very well, outpacing the market over a long period of time.

We have, in fact, as part of the Ostomy Care strategy, moved into collaboration with HSG to drive growth, very much in line with what we have done with Continence. Great patient care, a very much focused team on one side patients, on the other side insurance. And that model which we basically see as team selling between the Ostomy Care business and the HSG business started last year with a pilot and that pilot has been very successful.

So we are now expanding and that business is in fact doing very well off of, of course, a small base.

**Veronika Dubajova (Goldman Sachs):** Just one from me, please. Thinking about next year, just would love to get your thoughts. You previously made the commitment that 2021 would be the trough year for profitability. Just curious whether you are still comfortable with that? And maybe if you can help us think through some of the pushes and pulls that you see for margins as we think about 2022. And I am thinking both some of the non-recurring cost starting to roll off, so maybe not all of them. If you can give us some insights into that, your continuation of pressures from raw material and cost inflation. And then, of course, any investments as it relates to product launches as well? If you can just help us think through some of the moving parts. I am not asking you for 2022 guidance just yet but maybe just help us think through the moving parts.

**Frank Schulkes:** Okay. So in terms of do we think 2021 is a trough, I would say, yes. At the moment we think it is. And as you know, we are investing to pivot to sustainable profitable growth to grow in line or better than the markets of 4% plus and a gradual improvement in EBIT margin over time. And as we communicated before, also we do not see any structural reason not to be able to be in the mid-20s in the medium to long term.

Now without getting into guidance, let me give you a couple of factors here. So we are expecting non-recurring transformation investments to come down materially in 2021, but at the same time, we still see non-recurring spend going forward as, for instance, we are expanding, as I mentioned, the scope for GBS beyond finance. We have created a great platform here. And we are expanding that into IT and HR in 2022 leveraging that platform. And this is a multiyear programme and is a very important G&A project for us to improve efficiency and effectiveness.

Furthermore, of course, we are continuing to invest in IT and digital infrastructure, which will bring with its own non-recurring spend. I already mentioned the MDR for next year. And then beside a reduction in non-recurring, we will also see an annualisation of the recurring investments in our OpEx investments increase, as we have seen in 2020 and 2021.

And then, of course, we will invest to support the new launches that are coming down the pipeline in the next 30 months, and I will talk a little bit about that in a second.

So if you look at all of that, again, growing in line or better than the markets. We are pivoting towards that and a gradual improvement in EBIT margin.

Look, if you think about inflation, clearly, we have seen the impact and we feel the impact in the second half of 2021. It is probably fair to assume that some of that inflation will flow into 2022. It is very tough to forecast, at this moment, it is very fluid, but again some of that will probably flow over in 2022. So obviously in March when we do our full year results, we will have a better insight in sort of the macro-outlook related to that.

And then I think the last point here was regarding the new product launches in 2022 or over the next 30 months. So what we expect in 2022 is the launch of the Extended Wear Infusion Sets, which is a great differentiated infusion set, great for patients because in fact it increases the wear time from approximately three days to up to seven days. So that is a launch in 2022.

On top of that, we expect in 2022 to launch the GC Air male, so that is the compact catheter male in the Continence business. And then thirdly, we are expecting ConvaFoam, so the first product on this new ConvaFoam platform, better absorption, adhesion and those type of things in 2022.

And as I said in the 30 months, you can answer that later, so I think more 2023 timeframe, Avelle 2.0, for instance the female version of the compact catheter are some of the key launches. And then finally, we are working on refreshing the Ostomy portfolio. And our expectation is that that will come somewhere in 2023, the first we are targeting is the Esteem 2.0, which is basically a convex product line.

Finally, I forgot to mention here, also in 2022, we are expecting to launch t:sport, which is sort of an infusion set for a hybrid patch durable pump with Tandem. So we have a good pipeline here coming up in the next couple of years. We are of course investing behind that as well. I hope that answers your multifaceted question, Veronika.

**Veronika Dubajova:** Can I just quickly follow-up on something here. So you said in the mid-term you still feel comfortable with the mid-20 margin. I mean, do you think that improvement is kind of even paced if I think about 2021 to say 2025 to 2027? Or is it more front-end loaded or back-end loaded as you think about you guys moving towards what you see as that sustainable mid-term margin?

**Frank Schulkes:** Yeah. So first of all, we indeed do not see any structural reason to be able to be in the mid-20s in the medium to long-term, okay? So that is how we think about it, medium to long-term. And we believe it is a gradual EBIT margin improvement. It is a gradual. For all the reasons I just mentioned, right? Non-recurring coming down, still some non-recurring MDR and then annualisation and investing behind, of course, the great products and the pipeline we are developing here. So that is basically how we have to think about it.

**Veronika Dubajova:** Okay. I guess, I will have to wait till next year.

**Craig McDowell (JP Morgan):** It is another one on pricing, please, but specifically on your Infusion Care business. Just considering other B2B businesses that we covered, typically there is more of a contractual mechanism which would a lot of pass-through raw material inflation. Can you comment whether that is the case in your IC business? And if so, what kind of offset inflation should we expect and over what time period? And similarly, could this pass-through pricing mechanism actually be a tailwind to growth in the IC division in the near-term?

**Frank Schulkes:** Okay. Yeah, I prefer not to reveal contract terms in our contracts within the Infusion Care business. We have long-term contracts with our customers and they are typically indeed five years. There is some indexation here. It is also triggered at certain points, but I prefer not to reveal too much about the content of those contracts.

The business is performing very well. The market is doing very well. We have great differentiated technology that we have developed sometimes in collaboration with our customer base. And we expect that this will continue to do very well over a long period of time. We expect also that this market, given the smart glycemic control has indeed the potential to sustainably grow in the higher single digits.

Okay. So thank you very much for participating. Of course, for further follow-ups, Kate will be available going forward. And we will probably talk to several of you over the next couple of weeks. And if not, then we will see each other in the New Year when we will announce our full year results. Thank you very much and have a great weekend. Bye-bye.

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