Procaps Group
Conference Call Transcript
2Q22 Results

Operator:

Good day and welcome to the Procaps Group Business Update call and webcast.

Today’s conference is being recorded. Please note that some statements made during this call may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and are subject to risks and uncertainties. Any statement that refers to expectations, projections and/or future events, including financial projections or future market conditions, is a forward-looking statement. The Company's actual future results could differ materially from those expressed in such forward-looking statements due to a variety of risks, uncertainties, and other factors, including, but not limited to, those set forth in Procaps Group’s SEC filings.

Procaps assumes no obligation to update any such forward-looking statements. Please also note that past performance or market information is not a guarantee of future results.

At this time, I would like to turn the conference over to Melissa Angelini, Investor Relations Director of Procaps. Please go ahead, Melissa.

Melissa Angelini:

Thank you, and good morning, everyone. Thank you for standing by, and welcome to the Procaps Business Update call. This conference call is also being webcast, and a link to the webcast is available on the Procaps IR website at investor.procapsgroup.com. We appreciate everyone joining us today.

Please note that our press release was issued yesterday and can be found on the Procaps IR website. Please, review the disclaimers included in the investor presentation.

During this conference call, non-GAAP financial measures will be discussed and presented. We believe non-GAAP disclosures enable investors to better understand Procaps’ core operating performance. Please refer to the investor presentation for a reconciliation of each of these non-GAAP measures to the most directly comparable GAAP financial measures.

Hosting today’s call we have Ruben Minski, our CEO, and Patricio Vargas, our CFO.

I will now turn the call over to Procaps’ CEO, Ruben Minski. Please Ruben, go ahead.

Ruben Minski:

Thank you, Melissa, and thank you all for joining us today on our 2Q and 1H22 conference call.

As an agenda, I wanted to provide everyone with an overview of our 1H22 performance, as well as give an updated perspective on our strategy going forward. From there, I will turn it over to Patricio to take you through the more detailed specifics of our financial statements. At the end of our call, Patricio and I are both happy to answer any questions that you may have, and additionally please feel free to follow up as well with a post-call with either us or Melissa.

Moving to slide 5, I wanted to share some highlights of the quarter with you. On top line sales and market share positioning, we are doing well. Overall, our results show the resilience of our business segments and portfolio diversification that continues to evolve with new products and new geographies.

We posted a 14% increase in net revenues for the quarter and 12% for the 1H22, with our CDMO business growing 20% in the quarter. On the B2C business, we posted an 11% growth in the 2Q22, impacted by foreign exchange impacts, supply chain challenges and inflationary pressures.

On a constant currency basis, our 1H22 growth was 18%.

Our CDMO business is doing extremely well, with an increase in sales of existing partners and the launch of new products. I am also happy to report that our West Palm Beach Facility commenced operations, and we have seen some revenues from R&D services rendered.

The investment rationale behind this acquisition was that it was incredibly important for Procaps to have U.S. CDMO capabilities to better service inshore the largest pharmaceutical market in the world, as well as our European customers. We are already seeing progress on that end.

The construction of our gummy facility in the U.S. has been on track, and we expect to begin operations in 1Q23.

For all our divisions, except for Diabetrics, we are growing at double-digit growth rates, in terms of revenues on a constant currency basis. Our growth has remained consistent across our products, despite currency devaluation, as well as the launching of new products. Our new product launches have been a key driver of our growth, and I will share more light on those later.

Our renewal rate, which is the percentage of our revenues from recently launched products, is at 21%. This ratio is impacted by the phasing of some regulatory processes. As you all know very well, the launch of a product in this industry depends on the registration approval, which does not have a specific date, only a time range we believe the product will be approved. And today, we have over 170 products under registration, in different stages.

As we continue to navigate through this dynamic operating environment, we remain committed to our investments to fortify our businesses, portfolio, organization structure, and value chain, by increasing our production capacity, continued investment in R&D and new products, and expanding our geographic footprint.

On that note, as you know, during the quarter we proudly announced the acquisition of Grupo Somar and our entrance into Mexico. This transaction represents a significant step forward for Procaps' regional consolidation, expanding our reach into the second largest pharmaceutical market in LatAm, and offers a unique opportunity to realize significant synergies through cross-selling opportunities, leverage our innovative oral delivery technologies, and cost efficiencies.

Moving to slide 6, I want to remind you all about the strategic rationale of this transaction. As I just mentioned, our entrance into Mexico, which is the second largest pharma market in LatAm, is a very important milestone for us.

First, Grupo Somar is well positioned to capitalize on the tailwinds underpinning the Mexican market and sustain a high and consistent growth rate across its different business lines. We also have business growth leveraging from Procaps' highly differentiated portfolio in Mexico, and we are strengthening our CDMO business with our know-how and patented technologies, which we expect to broaden our customer list and portfolios in Mexico.

The second is the attractive product portfolio of branded generics targeted to the private market, and with leading market positions across key categories. Grupo Somar participates in segments familiar to Procaps, and both organizations complement each other's portfolio. Their well-diversified portfolio across other segments, therapeutic areas, and customers, with no relevant product concentration, creates also a great competitive advantage for us.

Third, this will also help us broaden even more the diversification of our revenues, not only with portfolio increase, but also with a new region, and it might offset some of the negative currency devaluation challenges we are facing, minimizing possible operational risks.

Fourth, Increased manufacturing and research and development capabilities. Six manufacturing facilities in Mexico, which include three FDA approved facilities, one of them being a Softgel capsules manufacturing plant. Manufacturing capabilities for several pharmaceutical forms that will support our growth the region, corporate manufacturing model to capture significant mid-long term operational synergies based upon specialization, production capacity to fuel geographical portfolio expansion to all countries where we operate, and research and development expansion by integration with Procaps R&D team, targeted at pipelines with very much of a regional reach.

Fifth, we have a strong local management team. An excellent team, with ample industry experience, and that will stay with the Company for years to come.

Sixth, significant synergies through cross-selling opportunities and cost efficiencies.

Finally, we expect to have approval by the Mexican authorities by 3Q22, and will start implementing our integration plan immediately afterwards.

Moving to slide 7, another important driver for our future growth is research and development and new products. As I always say, innovation around our proprietary oral delivery systems is the key to our success.

We launched over 120 products in the region during 1H22. A few examples: Deferol K, the first exclusive combination of vitamin D with vitamin K2 in Colombia and the region. We have also developed a gummy version for this product, which has contributed to its acceptance by pediatric patients and medical community.

MENTSI is the first specially formulated oral pharmaceutical grade mint oil used for stomach/intestinal disorders, such as irritable bowel syndrome. We have also launched our oncology line with ALUDEL, indicated as first-line therapy for men with prostate cancer that no longer responds to hormone therapy or surgical treatment.

We continue to invest close to 5% of net revenues in research and development, and we will continue to prioritize investments in our pipeline and business to realize the value of the many near and long-term opportunities in front of us.

With that, I will ask Patricio Vargas to review our financial statements before we take Q&A.

Patricio Vargas:

Thank you, Ruben. In the next slides I would like to give you a little more color on the 2Q and 1H22results.

Moving to slide 9, you can see our top line evolution. In the chart you can see our seasonality at play, as sales increase in each quarter in 2021 and 2022. Looking at the 2022 figures so far, we showed a strong performance in the 2Q and six months, with a net sales growth of 14% and 12%, respectively. The increase was mainly driven by positive performances in CAN, Nextgel and CASAND business segments.

As Ruben mentioned, we are facing some challenges external to our operations such as a strong currency devaluation, especially in the Colombian Pesos, which affects almost 50% of our revenues; global supply chain restrictions, that impact availability and pricing of certain raw materials; and inflationary pressures and economic uncertainties.

The diversified nature of our business helps us offset many of these challenges, which is helped by our ability to adjust prices in certain products and markets. This strategy, however, has some natural delays, so we may experience short-term pressure in our margins as we adjust. On a constant currency basis, our revenue grew by 19% in the 2Q 18% in the 1H.

Moving to slide 10, I want to take a deeper dive into explaining our net sales growth. Our iCDMO business experienced strong demand from our clients, as well as from the launch of new products and R&D services that started in our West Palm Beach facility.

Net revenues grew 20% in the 2Q and 11% in the 1H. On a constant currency basis, net revenues grew 28% in the 2Q 13% in the 1H.

Procaps Colombia was the business unit most impacted by the currency devaluation, as Colombia is its biggest market. It experienced a decrease in the quarter, in addition to the currency devaluation, by a decrease of covid cases, directly impacting our Clinical Specialties line.

Looking at our OTC and RX lines, growth was approximately 20%, supported by the performance of products launched last year, and increased demand for existing products. Overall, although Procaps Colombia had a modest top line growth in the 1H of 4.2%, on a constant currency basis, that increase translated to 13%.

CAN, or Central America North, was positively impacted by the roll out of new products and portfolio expansion in several therapeutic areas, such as gastrointestinal and feminine care. Additionally, we have a low comparison base from last year, as we are now seeing the benefits of reducing inventories at our distributor levels, which was a negative impact for last year.

CASAND, or Central America South and Andean Region, grew 18% in 1H22. The increase was the result of higher demand and the rollout of new products in the region, such as FEROVAS, in which we used our Unigel technology, combining two different active ingredients, for the treatment of mixed dyslipidemia in the elderly population. On a constant currency basis, net revenues increased 19% in 1H.

Finally, our Diabetrics SBU decreased 20% for the semester, impacted by the closing of an important public health insurance provider in Colombia and currency devaluation. On a constant currency basis, it decreased 13% in 1H. For the quarter, Diabetrics decreased 10\%, and in constant currency, the decrease was 5%. Comparing with the 1Q22, Diabetrics grew 30% in 2Q, already showing signs of improvement.

Moving to slide 11, on the gross profit line, we reached US$120 million for 1H22, and a 61% gross margin. This result is due to a positive exchange rate impact on costs, of roughly 4% in the semester, and the sale of some brands in CAN, as part of our portfolio management efforts.

Our operating expenses increase by 22% in the 1H22 versus 1H21, due to the return of promotional events and stronger commercial efforts, increase in costs associated with higher personnel costs, and costs of being a public company. We are also structuring the Company for the future growth with new hires and processes improvement.

Our adjusted EBITDA increased by 13% to US$37 million. Our EBITDA margin for the 1H22 is flat when compared to 1H21, in spite of our investment spending behind new product launches and facilities improvement, hiring the new team to handle our growth plans.

We have seen an increase in absolute adjusted EBITDA, despite some unfavorable market conditions that are important to highlight. Currency devaluation generated a translation effect in our posted figures, and as our main market is Latin America, currency fluctuations are a part of it. We are also facing inflationary pressures and supply chain challenges. We are working on price increases, improvement of our product mix with new launches, containing costs, so we can protect our margins going forward.

We are very happy with our results so far, and optimistic about our ability to deliver growth in the long term. However, should the present challenging conditions remain in the current levels, we might face margin pressures that will be difficult for us to overcome in the short term, and could potentially negatively affect our adjusted EBITDA guidance. This negative effect could possibly be in the range of 5% to 10%, but we will keep working on different alternatives to make sure that we can offset all these difficulties.

Finally, on slide 12, as of June 30, 2022, we have a cash balance of US$38 million, and a leverage profile of 2.1x net debt to adjusted EBITDA. Cash decreased as we paid down more expensive short-term debt, and expanded the CAPEX compared to the previous years. Additionally, cash has also been used to increase inventories to provide support to the supply risks we have seen worldwide.

Our capital allocation priorities remain unchanged. We will continue to prioritize investments in our pipeline and business to realize the value of the many near and long-term opportunities in front of us. We continue to develop new products and technologies to increase and complement our product pipeline.

So, as you can see, we are executing our strategy designed to deliver strong growth and establish the necessary building blocks behind our growth drivers to achieve our 2022 targets. We are ready now to finance and carry out the Somar transaction the minute we receive the regulatory authorizations

With that, I will pass it back to Ruben.

Ruben Minski:

Thank you, Patricio, and thank you all for participating. As I said before, our results are indicative of the health and resilience of our business units, a diversified portfolio that continuously evolves, a broad geographic footprint with strong positions in our largest markets, and of course, our highly motivated and dedicated employees who focus on delivering value to patients.

We are demonstrating impressive resilience across all aspects of our business in a very challenging global environment, with variables that are not always within our control.

Of course, we remain quite optimistic and confident in our growth strategy, its focus, its significant moat, and its industry expertise.

Thank you so much for listening, and we welcome any questions that you may have.

Yan Cesquim, BTG Pactual:

Good morning, everyone. Just three questions here on our side. The first one is regarding Somar acquisition. I wonder if you could give us more color on the timeframe for the conclusion of the acquisition.

The second question is regarding Procaps Colombia. Should we see the revenue growth resume in the division still within this year, or should we continue to see this revenue line pressured by the unfavorable dynamics with the phase out of covid in the short term? We saw these revenues, the top line in this division was down 4.5% in this in this quarter, and the reason behind this is mostly because of the phase out of covid and the unfavorable dynamics with this phase out. But I just wonder if you think that we should see this revenue growth in this line resuming within this year, or if the short term should remain under pressure for Procaps Colombia.

And the last one, I think Patricio talked a little bit about this matter, but can you give us again the number of the organic revenue expansion in 2Q on a constant currency basis? I mean, you disclosed in your report the 18% growth of the 1H22, but if you could give us again the number for the quarter. That is it. Thank you very much.

Patricio Vargas:

Thank you. Regarding Somar acquisition, this is something that, of course, no one really knows. This is a very complex process, always when you need to ask for regulatory approvals. We believe it should be relatively simple compared with other processes because there is not much overlap, there is practically no overlap between the two companies.

So we think it should come relatively soon. Now, 'relatively soon' could be within a month, a couple of months. I cannot comment much about the process, but the process has been going, I would say, according to what we anticipate.

We said in the press release that we believe in the 4Q we should have news. Hopefully, it is in the earlier part of the 4Q. But again, we cannot guarantee that.

Regarding the second point, about clinical specialties, it is hard to say what is going to happen with covid. It is true that it has come down and that has affected clinical specialties. But we have a broad array of products, and we have been diversifying and reinforcing all those other products.

So we think that, in time, we are going to be able to overcome that. It is just a short term impact caused by the decrease of those type of products. So it should recover very soon, from that point of view.

Ruben Minski:

If I may just make a comment, very quickly, on Procaps Colombia, I think that the most difficult part for Procaps Colombia to deal with is the devaluation of the currency. We have been able to pass some of the price increases, some of the devaluation to the final consumers, to the clients, to distributors. But this takes longer because there are some contracts still ongoing. If the devaluation stays at this level, we may have some difficulties, as Patricio mentioned. But the growth of the Company in local currency is very healthy. The demand is quite strong, and we do feel, as Patricio said, that we have quite a mix of products that will allow us to overcome any difficulties or a particular one.

Please, go ahead, Patricio.

Patricio Vargas:

On the last question, the constant currency growth in the 1H was 18%, and in the 2Q it was 19%.

Yan Cesquim:

Okay. Thank you, Ruben and Patricio. It was very helpful.

Kemp Dolliver, Brookline Capital Markets:

Good day, and thank you. My first question relates to the contribution margin disclosures, which are very helpful. Could you give us some context with regard to how those margins should play out over time? Because each SBU has its own investment mode and priority of growth versus profitability. So if you can give us some perspective on what to expect with regard to the margin behavior over the next few years, that would be very helpful.

Patricio Vargas:

Thanks for your question, Kemp. There is a couple of factors that will impact on the margin going forward. In the short term, we are going to be it very much depending, for the immediate time, on the exchange rate, because we have expenses in Colombian Pesos. We have purchases in USD of raw materials. So that mix is going to be affected by that. So it is kind of hard for me to tell you where, for instance, could be the 2H. I guess, for effects of your modeling, stable is something reasonable.

Going forward, we should improve as we grow into different business areas and we put more capacity at work in the plants. We are going to become more efficient, so you should expect, production-wise, some efficiencies to be gained there.

And both when you analyze Procaps standalone, and in the future, when analyzing Procaps and Somar, we have a significant capacity to reduce and improve the costs of our different raw materials. So we expect an improvement across the line in terms of expenses. So that should have a margin expansion in the next year, hopefully.

Kemp Dolliver:

Thank you. Catalent reported earlier this week some challenges with their Softgel business. Your performance in the 1H was much better. Could you talk about the differences in your business versus theirs? And if there is any competitive dynamics that we are seeing here that are working to your advantage.

Ruben Minski:

That is a great question. We have found the same difficulties. These are real difficulties in the supply chain and management for our raw materials. For example, one of the issues was gelatin, it increased by 40% the price because the lack of raw materials. But we have been dealing with this. We have worked very much in cost efficiencies. We have high demand of our gummies' facilities, very high demand of some of the product from third parties.

So we are very pleased that we were able to weather the storm in the 1H. We do expect for the 2H for this to lower the intensity, and we expect to weather the storm as well for the 2H.

So these are challenging times, but nevertheless, we have been able to move very quickly and cover the difficulties.

Kemp Dolliver:

Do you think you are gaining share from them?

Ruben Minski:

It is very difficult to say that because there is no published public data for this. We have been moving along. We have been increasing our volume of manufacturing capsules, or capsules being manufactured, but it is very difficult to say. There is no data published in this particular area.

Kemp Dolliver:

Very good. Thank you. Has Grupo Somar's management remained stable since the announcement of the acquisition?

Ruben Minski:

Yes, absolutely. We have very talented people there, very good leadership. And yes, we have we have been able to work with them, and they will stay with us, hopefully for years to come.

Kemp Dolliver:

Excellent. Thank you for your answers.

Jason Kolbert, Dawson James:

Congratulations. What a great quarter. I just wanted you to talk a little bit about some of the valuation calculations, and particularly how accretive Grupo Somar could be if we look out beyond the year. What I am really trying to understand is the cross product synergies that exist as you start to push your footprint into Mexico.

Patricio Vargas:

Thank you for your question. That is something we are really happy with, not only going forward, but if you look at the first year, this deal is accretive for us; I would say marginally accretive in the first year. Of course, we are taking significant debt from what we had before. But of course, considering all of that, this is accretive.

But if you go beyond the year, this starts to grow significantly given all the cost synergies that we have, being so complementary to the businesses and being such a nice fit for our rollout strategy, our rollout expansion capabilities. Just to remind everyone, the way our business model works is that we register different products from certain countries into the other countries, and we register and we launch them.

So bringing Somar into Procaps is basically applying the same business model that we are doing on a bigger scale, which is taking their products and registering in our markets, taking our products, registering in Mexico.

Of course, you have to take into consideration the timings and necessary for the proper registration in each market. Each market is different, so it could go between two to four years. But accounting for that, the value that we can get for the group combined is huge. And that is why we are so happy with the acquisition.

Jason Kolbert:

That is what I am trying to understand. So if I were to look at your revenues outside of Mexico and do a market comparison of the size of the country versus where you are in now, and suggested that there is a significant double digit growth rate, I would be naive to model Grupo Somar based on their revenues. Instead, I have to model it based on the size of the market opportunity times the totality of the products in both companies, right? Is that the right way to think about it?

Patricio Vargas:

It is the right way, with a caveat. You need to take into consideration working capital restrictions, capacities that we may need to invest on, timing, type of product. It is not correct to assume that all the portfolio of both companies can be taken into all the countries. There are some products that in some countries may be old products, or that they may have too much competition.

So we need to do our very careful pick of which product we are going to take into each countries. But that detail analysis, we cannot do it until we are working with Somar and we have the approval from the authorities. But the estimates that we have, they look very promising. Once we are inside the Company, we will host a call at some point and update on this and give more granularity.

Jason Kolbert:

That is what I was hoping. That in six months, once you are there and kind of familiar with both the Company and the regulatory landscape in the country, that you would be able to revise kind of the forward looking accretion beyond the year, which would be helpful in terms of just modeling the revenue. Suffice to say, it is much greater than it is one year out.

Patricio Vargas:

That is correct. And we will do that. We understand it is important and if we do not give the right information, it is very hard for you to make the analysis.

Jason Kolbert:

Thank you so much. Congratulations on this first very critical step in the process.

Operator:

This concludes our question and answer session, as well as our conference for today. Thank you for attending today's presentation. You may now disconnect.