Procaps Group
Conference Call Transcript
4Q22 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 hello, 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. We appreciate everyone joining us today.

Please note that our earnings release and our 20-F were issued last Friday and can also be found on the Procaps IR website. Please review the disclaimers included in the investor presentation. During this 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 are Ruben Minski, our CEO; Patricio Vargas, our CFO; and me.

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

Ruben Minski:

Thank you, Melissa, and thank you all for joining us today for our full year 2022 results conference call. I want to start by addressing the negative effect of our results that impacted the 2H22, especially the 4Q in which those impacts were higher and worse than expected.

As you can see in this slide, up to 9 months of the year, we are able to compensate some business units performance with current evaluation with the overperformance of others. But in the 4Q, even with overperforming a part of the portfolio such as RX, it was not enough to compensate the negative effect that were even stronger quarter in this quarter.

The main impact of our COVID-related clinical specialty portfolio, we, as most players in the industry made the mistake thinking that the prices and demand with the Omicron variants would be similar or higher than the first wave. However, distributors and hospitals ended up with very high inventories due to the lower demand of this type of products generated by these new variants. We learned our lesson, and we have adjusted our forecast price and demand according to this new reality. Due to this, we made the necessary provisions and for 2023, this is already adjusted to the new demand forecasted.

The other major impact is currency devaluation, accounted for approximately US$28 million negative impact in our revenues for the year and US$12 million only for the 4Q. As expected, we had to comply with some of our contracts, which were agreed upon in local currency preventing us from increasing prices fast enough to compensate the negative effect devaluation was having in our margins.

Diabetrics was especially hit by currency devaluation, and Nextgel was also impacted by dronabinol with the still ongoing change of API manufacturing site and progesterone with ongoing bioequivalent tests. Both matters affected sales of 2022. Since we cannot sell those products until those matters are resolved. Both are expected in commercialization by the 1Q24. We are very pleased with the execution of our value creation initiatives taking place this year as an important measure to protect our margins and results going forward.

Looking ahead in 2023, with our focus on our strengths for growth and the substantial efforts we are putting in our strategic improvement initiatives. I am cautiously confident that we are well positioned to achieve our near- and long-term goals. We expect 2023 to be a year to stabilize and substantially improve our results so we can continue with our expansion plans. We reaffirm our guidelines, which you will see in the next slides, we will certainly find challenges but we are confident that we will properly address each and any one of them as they appear.

Moving to slide 4. Our new product launches have been a key driver of our growth. US$111 million in revenues from new products in 2022 and over 170 products in the registration phase. Our renewal rate, that is the percentage of our revenues from products launched in the last 36 months, was 27% in 2022. We have now commenced operations in our West Palm Beach facility, providing R&D services with a growing pipeline of contracts, RX and OTC products in development. Packaging services starting our new gummy manufacturing facility in Florida, full gummy production will commence in the second half of this year.

Additionally, we have implemented multiple initiatives to reduce costs, improve margins and near-term profitability as well as to expand our global reach with our roll-up strategy and to fund our growth.

Moving to slide 5. I want to share an update of the value creation initiatives we announced at the beginning of the year. Our goal is to achieve up to US$15 million of recurring savings to be realized over the next 18 months. Since the beginning of this year, we have been focused on these initiatives, including but not limited to SG&A efficiency, processes, operations streamline, R&D optimization and corporate expenses efficiency. As of March 2023, total execution of our savings capture rate was approximately 20% of our goal. As of today, I can tell you that we have captured more than 30%.

Moving to slide 6. Another important driver for our future growth is research and development of new products. As I always said, innovation around our proprietary oral delivery systems is key to our success. Our renewal rate, that is the percentage of net revenues from new products launched in the last 36 months, was 27% during 2022. Launches depend on registration approvals from regulatory agencies, and we could have facing from quarter-to-quarter depending on the time of these approvals.

We continue to invest approximately 4% of our net revenues in R&D. And we will continue to prioritize investments in our pipeline and business to realize the value of near- and long-term opportunities in front of us.

Ramp-up for product launches during 2022 is quite strong, highlighted by Aludel, oncological prostate cancer, Dolofen Extra that's an OTC product, Mentsi and PapiloCare in Colombia. Geo expansion including women's health, cardiovascular and gastro products are also performing very well, according to the ramp-up trajectory.

Moving to the next slide, looking into the year 2023, combined with our cost reduction plans to optimize our business in the near term without compromising our long-term objectives, we are forecasting our adjusted EBITDA range to approximately US$90 million to US$100 million in 2023 in constant currency. Our preliminary results for the 1Q are showing a positive turnaround with mid-single growth in net revenues and high single-digit growth in adjusted EBITDA in constant currency.

Now I will pass it to Melissa, who will share with you a little bit of our ESG progress.

Melissa Angelini:

Thank you, Ruben. With our focus on using science and technology for health and nutrition improvement through pharmaceutical and nutraceutical solutions, it's only natural to report our accomplishments and goals in ESG. Our commitments and initiatives include advancing a health, climate resilient future, social responsibility within the Company to support its philanthropic pillars and surrounding communities as well as United Nations sustainable development goals. To that end, we have several social initiatives in Colombia and throughout the region. And here, you can see one of them, which is called Hilo Azul, which impacted close to 3,000 patients in the Amazons.

On the people side, we continue to work for gender equality, and we recently launched a program to boost female leadership in different areas and countries. On the environmental pillar, we are working on our carbon neutrality strategy, and we expect to be ready to share it with you soon. We will continue to make significant progress across all of our corporate responsibility, and we expect to deliver our ESG report soon as well.

I will now pass it over to Patricio, who will comment on our operating results.

Patricio Munoz:

Thank you, Melissa. Before discussing our performance for the quarter and the full year, I would like to take this opportunity to apologize to our shareholders and to explain the reason for being delayed in our 2022 filing. We recognize this delay is bad news, especially in a time with challenged results, while at the same time, we are working to improve our systems and processes and build trust as a relatively new public company. We expected our new consolidation system to be in place by December, but we were delayed in its implementation, especially in what it pertains to the interconnection to the different affiliates. We are now expecting it to be operational for our 2Q filing.

At the same time, we have continued working on remediating our material weaknesses, which must be dealt with to achieve the accounting and control standards our investors demand from us. We expect the remediation plan should be mostly implemented within the next 18 months or by the end of 2024.

Now moving to slide 9. You can see our top line evolution. Currency devaluation, especially in the last few months of 2022 negatively impacted our revenues by US$12 million in the quarter and by US$28 million in the full year. Excluding this impact, in constant currency, we ended with an increase of 6.8% for the full year 2022. This was primarily due to an increase in demand for our products and services across 3 strategic business segments: Nextgel, CASAND and CAN and the rollout of new products. Our top line performance was broad-based across several therapeutic areas.

In general, the main drivers for growth were increased demand for RX and OTC products, the rollout of our existing portfolio with new product launches, the higher market penetration in the Andean region and higher demand for products and services for third parties.

Our top line growth in constant currency is a result of our diversified portfolio, brand and market share execution. The Nextgel business segment is growing consistently, and the demand from regional and global partners remain strong.

Procaps Colombia was the business unit most impacted by the currency devaluation, as Colombia is our biggest market. In addition to the currency devaluation, it experienced a significant decrease in sales for the most relevant products for the ICU in our clinical specialties line. In total, Procaps Colombia increased 4.2% in 2022 on a constant currency basis. Looking solely at our OTC and RX lines in Colombia, the lines are growing healthily, supported by performance of products launched last year and increased demand for existing products.

CAN, or Central America North, was positively impacted by the rollout of new products and portfolio expansion in several therapeutic areas, such as gastrointestinal and feminine care. The low growth for this quarter is mostly related to a high comparison base as in the 4Q21. CAN started to increase its sales after an 18-month period of inventory normalization in the trade, which caused lower-than-normal sales in the previous quarters. Net revenues in 2022 increased 8.9% versus 2021, impacted by positive performance in Guatemala and Nicaragua.

CASAND, or Central America South and Andean region, grew 21.8% in 4Q22 on a constant basis and 23.9% for the full year 2022. The increase was the result of higher demand and the rollout of new products in the region and the increased market share of existing brands.

Finally, our Diabetrics SBU decreased 22.9% in the 4Q and 18.1% in the full year on a constant currency basis. Revenues were impacted by currency devaluation, lower sales of our differentiated metformin portfolio threatened by lower prices, given the entrance of multiple pure generic competitors, lower prices for certain products due to more competitors and EPS budget restrictions.

To sustain our margins, and the business in the long term, we have taken several measures, such as cost reduction initiatives, lower volume sales to protect prices, sales increase in the private channels, price increases during 2023, development of new technologies for the years to come with novel fixed dosage combinations for our antidiabetics portfolio and novel glucose monitoring system, rollout of the business model to other countries. We have launched in El Salvador and Ecuador, and we just received approval in Mexico, and we expect to launch during this year.

Although in the long term, we have ways to transfer some of these impacts to the market, we must continue to monitor the evolution of the currencies where we operate, but especially that of the Colombian peso, given its way in our results. As a follow-up for 2023, our 1Q revenues have also been affected by currency devaluation.

Moving to slide 10. On the gross profit line, we reached US$52.3 million in 4Q22 and US$239.6 million for 2022. Gross margin was 51.5% for 4Q22 and the full year gross margin improved to 58.4%. This result was mainly due to the product mix sold. We are also showing our consolidated distribution margin, which includes the impact of sales and marketing expenses and we have been able to defend the margin in these challenging markets. You can see that we are improving and the business margins are solid even with the higher expenses period.

Moving on to the next slide, we have the breakdown of our operating expenses and adjusted EBITDA. In addition to the impact we had in the top line in U.S. dollars by the exchange rate, in this slide, you can see that SG&A is impacting our EBITDA as we continue to invest in our product brands to increase market share, reinforcing the organizational structure and preparing the Company for future organic and inorganic growth. SG&A expenses increased by 27.1% in the quarter and 20.7% in 2022, mainly due to Rymco medical impairment, higher transaction expenses related to M&A and being a publicly listed company. The return of in-person promotional events and stronger commercial and marketing efforts and the preoperative expenses related to the West Palm Beach plant.

All of these expenses negatively impacted our adjusted EBITDA, which totaled US$10.6 million in the quarter and US$7.1 million in 2022. We are working on price increases, contract adjustments, improvement of our product mix with new launches and containing costs so we can protect our margins going forward. Also, as we continue to grow as planned, we will be diluting most of these expenses as well as reducing some of them as we become a more efficient organization in our new context. Despite these hurdles, we are optimistic about our ability to deliver growth in the long term. For the time being, as we are not blind to the challenges, we will continue to work in a disciplined and creative way to improve our results quarter-over-quarter.

Turning to slide 12, our balance sheet and indebtedness. Our cash balance has decreased as a result of increased working capital gains, increasing inventory to provide support for the supply chain challenges we have been facing, increased expenses associated with being a publicly listed company and additional expenses related to projects, increased CAPEX as we return to normal levels prepandemic. Lower cash generated by the business as we took a hit in our results for the reasons we have already explained.

Due to this, our net debt levels have increased with a resulting 3.5x net debt over adjusted EBITDA ratio. An important issue you can see in this slide is how the short-term debt significantly increased by the end of the year. This was the result of us not being in compliance with certain of the covenants included under some of our loan agreements. The decrease in our operating results, combined with higher expenses due to the M&A activity we carried out last year, put pressure on our financial ratios.

Although none of our lenders declared an event of default under the applicable agreements, and we subsequently obtained waivers from such lenders for their respective noncompliances. These bridges resulted in the lenders having the right to require immediate repayment of the applicable indebtedness. As such, we classify the respective indebtedness amounting to approximately US$139 million from long-term debt to current liabilities. Given that we already have the waivers, we expect to reclassify our debt back to long term in the subsequent filings. The details on the calculation of covenants are included in the 20-F, which was filed on Friday.

In summary, although we are facing some challenges external to our operations, such as strong currency devaluation, global supply chain restrictions and inflationary pressures and economic uncertainties, we are confident in the fundamentals of our markets, and we believe we will see operating leverage as we continue to grow our revenues and after we continue on executing our value creation initiatives.

With that, I will pass it on to Ruben.

Ruben Minski:

Okay. Thank you all for participating. We are demonstrating risks across all aspects of our business in a very challenging global environment with variables that are not always within our control. We are growing in constant currency, and we are making the necessary investments in our businesses. We also expect to see operating leverage as we continue to execute on our value creation initiatives.

We are absolutely convinced that the fundamental growth drivers are improving substantially. And here is why we are confident that we will reach our 2023 goal and guidance. We are on track in executing our value creation initiatives. We continue launching products and we are expecting revenues of over US$20 million for new product launches only in 2023, as well as continued rollout of our existing portfolio in countries where we are present.

There is a healthy demand for RX and OTC portfolio of ours. We are partnering with local manufacturers in CASAND region to increase market penetration. We are very objective with our capital allocation and business expected to have more cash generation. We expect higher growth of our CDMO services and products, focusing on highly regulated markets with the launch of new products and new gummy facility in the U.S. and mostly in the 2H23.

And inorganic growth is still quite significant part of our strategy. We are working on profit stabilization and increase to regain our leverage capacity and continue with inorganic initiatives. We are also investing in strengthening our process and resources to support our future growth, especially in our accounting area.

Finally, I strongly believe that we have the competitive advantages, the capabilities, the right team and the effective strategy to continue growing, even in challenging scenarios.

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

Samuel Alves, BTG Pactual:

Good morning. I have 2 questions here. The first one is regarding the 2023 guidance that you maintained. When you look at the full year guidance, this implies 30%, 40% growth in constant currencies, but you are also guiding for the 1Q of the year, flattish EBITDA. So it's just to add, if you could add some color here to the full year guidance, if you expect a much better 2H23, it would be great. This is the first question.

And the second question regarding the specialties. When you look at the 4Q results, apparently, the 4Q results were negatively affected by high inventory levels at your clients. So if you could at least share with us if you see if these inventories already normalized in the beginning of the year would be great. That's it.

Patricio Munoz:

Thank you for your questions, Samuel. Patricio speaking. So going to your first question, 2022 was a very challenging year. And the last part of the year, the last few months were significantly more so. There is some lag in recovering and the 1Q, that's why you do not see a better 1Q and what we are anticipating and giving to the market. But that is only natural after coming from a very tough 4Q.

We mentioned that we are cautiously optimistic about 2023 , and we are standing by an aggressive growth, as you mentioned, 30%, 40% growth because we believe there are good arguments.

Let me try to share that with you. I am going to try not to be too long. But first, one of the big impacts we had last year was FX. It's impossible to predict where the FX will go. But from what we are seeing now, it has been more stable in the first 4 months of the year. And different than last year, we have now implemented a hedge covering our net exposure for EBITDA, revenues, minus expenses we have roughly 60%, 6-0 percent of our exposure covered with hedges now that we took at the beginning of the year.

So from that point of view, even if there comes a new devaluation, we should not have such a big impact, okay? And if there is an improvement, well, we should have some of the benefit with that 40% that is not covered. So that's one issue. Second issue, we have this value creation initiatives, the cost reduction initiative we have discussed. Most of them have already been implemented. We are on track with that. The risk of achieving those is very low. It does not depend on anyone, but on keeping those expenses or costs down. So that is the second point.

The third one is, probably here I am jumping into your second question. One of the big impacts in the year 2022 was the ICU problems we had in the clinical division. That was a very big impact in revenues and also in terms of provision for the 4Q because we had inventories that were not going to be sold in the end. But that is not a problem for the year 2023. We have already recognized the full provision of those inventories in 2022. And we do not consider in our guidance, increasing revenues in this area. So therefore, we do not have that negative from that point of view.

We do have stronger contracts coming in place for our CDMO division in the second half. So there will be for that business unit, a stronger second half of 2023. And going to the basic of our core business, when you look at the demand growth for our prescriptions, in Colombia and in other markets also in CASAND, the growth you see in CASAND is roughly 20%. Depending on the country it will be slightly low, slightly higher, but that's what we are seeing in the first part of the year and what we saw in the last part of the year, when you remove all the negative effects.

So when you combine all of those 5 reasons, we believe that although it's challenging, it's a significant growth, and it's not going to be easy, and we are going to have to make it every day. We think there's some probability for us to meeting the guidance we gave. So we are standing by that, okay? I hope with that I answer your first question.

And the second question, I touched it briefly before. Given that sold and prepared to sell significant products for ICU. In products related to COVID hospitalization at the beginning of 2022, and that did not materialize. Both ourselves, some of our competitors and our customers, we were all having or in possession of high inventories and those inventories after 1 year. And after seeing that we are not going to have revenues or significant revenues from that going forward, we had to make a provision for that in the 4Q. So the bad news was real, and it impacted us very strongly in the 4Q. But for the year 2023, we have, I want to say, like a clean slate going forward.

I think those are your 2 questions, Samuel.

Kemp Dolliver, Brookline Capital Markets:

Thank you. Good morning. I have a handful of questions. The first relates to the CDMO business. Over the course of the last week, Catalent has announced they were taking a write-off of part of the purchase price for Bettera. They have talked about end market weakness. At the same time, your business is performing better, and you have just mentioned you are taking on some new contracts later this year. Are you taking market share in this business?

Ruben Minski:

It is somehow difficult. There are no statistics to confirm that we are getting a larger market share. But definitely, especially with the U.S. start-ups, we are getting much more visibility, and we definitely have a lot of RX, OTC and gummy products in pipeline, which creates a lot of confidence for us that we are getting it. But the answer is that we do not actually have that in our hands to be able to confirm that opinion.

As far as Catalent, if I am not mistaken, their comments are more related to other areas, not so much to softgel gelatin capsules, which we see as a growing business. We do not feel that we are growing much better than they are, but it's not related specifically to the side of the business, which we are competitors of them.

Kemp Dolliver:

All right. Thank you. The second question is the value creation program. And when you talk about the savings that you are realizing, for instance, in the press release, you mentioned US$3 million, and it looks like you have already moved back to US$4.5 million. Are those numbers annualized? As we model, do we need to take that into account? Or are these actual savings that we would see immediately as you report the quarters during 2023?

Patricio Munoz:

Thank you for your question. That is not an annualized value. It's the value for the respective quarter. So you are going to see when we report the 1Q as part of the number we gave us guidance, those US$3 million are already in there are helping the business. The additional that we already see as captured in what we have so far in the quarter, it's a realized value. So we are very optimistic about this plan.

As I mentioned before, it comprised initiatives of cost cutting efficiencies and other initiatives of like real measures that we implemented and have already been captured. So what we are going to have, that is a recurring value that we are capturing in the following quarters.

Kemp Dolliver:

Great. Next question relates to the Diabetrics business. You had a difficult year, you articulate the challenges you saw in the 4Q. How are you thinking about the prospects for this business long term? Because when we first started talking about, it looked like a very interesting approach that would have some competitive moats that seem to have been pierced recently. So how are you thinking about it now?

Patricio Munoz:

Regarding Diabetrics, it was a really tough year. If you remember, we started with the bad news of one of our main customers going technically broke. So we lost a significant revenue in the first 2 quarters because of that. And after we started recovering from that, we had some issues with the supplier of one of our products. We had a new competition for others.

So it was a bad year for that specific business unit, but we are optimistic for that one for the future, not only for launching in new countries which we stand by the beauty of that business model we have in which in one business unit, we have everything related to diabetes. But we are also completely having more devices. So that's why we are so optimistic about this business going forward. So that's basically it, Kemp.

Kemp Dolliver:

Yes. Is there anything in there with regard to your launching that would help reestablish the proprietary nature of the offering that you had 2 years ago, for instance, or a year ago?

Patricio Munoz:

Kemp, we have some new ideas coming, but we cannot say it right now. So again, it's part of our optimism that new products will come, but I cannot say anything right now.

Kemp Dolliver:

Thank you. Two more questions. First is with regard to your working capital levels, what are your plans for reducing those back to normal levels?

Patricio Munoz:

That's a very good question, and it's part of our efforts of our value creation initiatives, we underwent a significant increase in our inventories in the past year. And we need to focus on that. I think one of the areas where the Company has been lagging behind is in cash. So we have a team dedicated to try to reduce the working capital. I cannot commit to a number here. But we are going to keep you informed about that. But it's one of the objectives for this area, to reduce the working capital in the next 2 quarters.

Kemp Dolliver:

All right. Thank you. And my last question relates to Rymco and the write-down there. Could you just quickly elaborate on what happened there?

Patricio Munoz:

Okay. Rymco, Looking at the last part of the year and seeing all the challenges and seeing the cash consumption, we said, okay, we need to be very focused on where we are going to allocate resources. So we decided we are going to make efforts in focusing on others and divesting or getting out or reducing ours.

In that sense, Rymco Medical, we think it is a good business. We just think it's not the best business to be or to remain in our hands. So we decided to lower the efforts done in that business. And when you do that, of course, your projections going forward are reduced. And of course, when you reduce the projections of a unit, you need to make the necessary adjustments. And that's why we had to record an impairment.

Right now, we are evaluating whether during the year, we should get out of that business, sell it, continue a smaller version or shut it down. We are still under evaluation. But we have already reflected the impacts of any of those measures. Probably if we sell it and there's value there, we can recover part. But we are very conservative. So we prefer to make that impairment; which was, by the way, US$6 million.

Kemp Dolliver:

Right. And just quickly, what's the size of this business in terms of revenue or assets?

Patricio Munoz:

It's not a big business. Actually, I do not think we have ever disclosed the figures of this. Out of the top of my head, US$10 million, a bit more revenues. In revenues, roughly US$10 million. It's a business we acquired several years ago.

Operator:

At this time, there are no more questions in the queue. This concludes our question-and-answer session as well as the call. Thank you very much for your attendance on this presentation. You may now disconnect.