ConvaTec Group

2021 Interim Results with Q&A

30 July 2021

Transcript

Karim Bitar: Good morning. And it's great to be with all of you today and delighted to have the chance to review with you the first half performance of ConvaTec in 2021. What Frank and I would like to do today is to really discuss with you three key topics. The first thing we'll do is to review how did we perform financially in the first half of the year and Frank will discuss that with all of us. Second, I'll try to provide you with some colour in terms of our transformation strategy. How are we executing on that? How much progress are we actually making? I think you'll hear us highlight to you how we are very much pivoting to sustainable and profitable growth. And thirdly, and lastly, we'll try to provide you with a little more colour in terms of what our future growth prospect's looking like. But I'd like to highlight to you is that at 11:00 AM British summertime we will be holding a live Q&A. And now at this point, what I'm going to ask is for Frank to take the baton and to lead the discussion around our first half financial performance and highlight and showcase our strong results. Thanks.

Frank Schulkes: Thanks Karim and good morning. Thank you for joining us today. Let me take you through our financial results in more detail, starting with our highlights on slide four. We achieved a strong financial performance across the group in the first half of 2021 as we continue to execute our FISBE strategy. Group revenue was just over $1 billion, increasing 11% on a reported basis or 7% on a constant currency basis. This strong performance was ahead of our expectations and principally reflects the rebound in advanced wound care against the COVID depressed Q2 last year. Coupled with good growth in infusion care and a solid performance in continence and critical care as well as Ostomy care. Our adjusted operating profit rose 12.4% to $204 million and was about 17% up in constant currency. The EBIT margin was 20.3% compared to 20% last year. And there were a number of moving parts behind us which I shall cover shortly. Diluted adjusted EPS rose 18% to 7.2 cents and a seven and a half million reduction in net finance cost was offset by the rise in the effective tax rate from 19% to 19.8%.

Frank Schulkes: We are declaring an interim dividend of 1.717 cents in line with last year. We generated $114 million of free cashflow with cash conversion of 57% and I'll share more detail on this later as well. Finally, the balance sheet remains robust with leverage at two times net debt to EBITDA similar to year end and consistent with our target of at or below two times.

Frank Schulkes: Moving to slide five, where you can see the key drivers of our 7% constant currency growth rate during the first half. The most significant contributor was advanced wound care. Revenues rose 10.7% even after the 12 million headwind from the disposal of the US skincare product lines at the end of Q3 last year. Ostomy care, growth was 3.7% with approximately 90 basis points of revenue headwind driven by a plant contract and product rationalisation. Continence and critical care grew 6.8% with just over half the growth derived from the Cure Medical acquisition. Adjusting for Cure organic growth was 3% with growth incontinence care offset by slightly slower growth in critical care as demand for ICU products moved into decline as anticipated as the period progressed.

Frank Schulkes: Finally, infusion care delivered 6.5% growth in a year with a continued good performance in the smart glycemic control segment. Reported revenues rose 11% reflecting approximately 400 basis points of FX tailwinds. The disposal of the US skincare product lines and the acquisition of Cure Medical broadly offset one another so group revenues grew 7.4% on an organic basis. The impact of COVID has increased quarterly volatility in the growth rates across the group, but we remain positive about our long-term growth prospects.

Frank Schulkes: Moving to page six. Trends in advanced wound care and critical care suggested COVID is beginning to normalise in our major markets as the rollout of vaccine programs progress. However, although our global emerging markets performance in the first half was positive we're cautious about more recent lockdowns, particularly in Asia Pacific and Latin America. Our wound care business revenues were $294 million in the first half of the year.

Frank Schulkes: If we exclude the impact of the skincare disposal, the business was up 16.3% on an organic basis. A strong performance was anticipated given the weak COVID depressed comparative period last year, particularly in Q2. This reflects improving trends in elective surgeries and access to clinicians in Europe and North America, coupled with positive phasing and better commercial execution resulting in a stronger than expected performance. Overall, if we adjust for the COVID impact and other one-offs such as phasing, we estimate underlying growth in the first half was between 4 and 5%. From a geographic perspective our Latin America and Asia Pacific businesses continue to perform strongly throughout the period, supported by the step up in government spending on healthcare since the pandemic began, which is expected to normalise in due course. Europe bounced back during the first half while after a slow start performance in north America recovered well during the second quarter.

Frank Schulkes: Encouragingly, we saw strong growth across all the segments. As we look forward, while we're positive about the improving trends in elective procedures and the commercial execution improvements, we're mindful that the second half comparatives are relatively tough compared to the first half. We're also aware there continues to be underlying uncertainties related to COVID and some headwinds such as the French reimbursement cut. Our continence and critical care business delivered 266 million of revenue. This included a nine and a half million dollar incremental contribution from the Cure Medical acquisition, which completed in March. The integration is progressing well and the business is performing as expected. Organic revenue growth was 3%. Within this, the continence care and critical care performances were broadly similar, although the trends are different. Our continence care business grew 3.3% on an organic basis to $184 million. This moderate growth was anticipated given the impact of lower new patient starts across the segment during the pandemic. During the course of the period, the NPS gradually recovered and has now returned to pre COVID levels, although some products such as incontinence continue to be challenged.

Frank Schulkes: Critical Care grew 2.3% in the first half. As expected as the half progressed demands for our ICU products began to decline moving from 7% growth in Q1 to a decline of over 2% in Q2. Although the latest wave of COVID continues to create challenges around the globe, in Critical Care's primary markets such as the US and Europe the vaccine programs appear to be progressing well and having a positive impact on ICU rates. Looking forward, we expect more moderate growth for triple C in the second half, given more significant declines in critical care and continued modest growth in continence care.

Frank Schulkes: Moving on to the next slide, slide seven. The Infusion Care business delivered 175 million of revenue in the first half up six and a half percent in constant currency. The growth continues to be driven by strong demand for innovative infusion sets, which are a core element of the growing smart glycemic control segment of the diabetes market.

Frank Schulkes: This was supported by good growth in non diabetes infusion care, albeit of a very small base. Overall growth is thought to be broadly in line with the markets. The order phasing was uneven and resulted in Q1 delivering our largest quarter on record of $93 million while Q2's year on year growth was subdued. We're confident of another half of good growth, but it is expected to be weighted to the later part of the year. Finally, our Ostomy Care business achieved $273 million of revenues up 3%, 3.7% on a constant currency basis. This was primarily driven by continued good growth in Latin America and Asia Pacific supported by the government healthcare funding programs and coupled with a solo performance in North America supported by stocking trends. In certain European markets, we continue to experience challenges, which is offsetting growth in areas such as Italy and central and Eastern Europe.

Frank Schulkes: The growth was also moderated by a plant contract and SKU rationalisation, which is estimated to have reduced growth by approximately 90 basis points. Looking forward we expect to see growth, although destocking is anticipated. And in Q4, we will begin our second round of rationalisation so the impact will become more pronounced.

Frank Schulkes: Moving on to gross margin and OPEX on slide eight. Starting on the graph on the left. Our gross margin rose 60 basis points in a year to 60.6%. There was about a hundred basis point FX headwind so if you adjust for FX, gross margin would have been up 160 basis points year over year. We saw the positive impact from productivity initiatives and price mix benefit more than offsetting the inflation and cost of goods sold, which began to expand as the period progressed.

Frank Schulkes: Moving to OPEX on the right. This graph shows the breakdown of our operating expenditure, including the recurring transformation investments, but excluding the non-recurring transformation investments. If you are interested, there is a slide in the back illustrating spend, including the non-recurring investments. Total OPEX, excluding non-recurring transformation expense grew to 38.2% of revenues partially impacted by FX. The largest step up was in selling, marketing and distribution, which rose to 24.7% of sales. This reflects the increase in recurring strategic investment, coupled with a rise in travel, advertising and promotional spend, as COVID begins to normalise. We spent $96 million on G&A or nine and a half percent of sales. And we expect G&A as a percentage of revenue to continue to come down over time as we see the benefits coming through from projects like GBS, as they are fully implemented and scaled. R&D rose 14% to $40 million or 4% of sales. We expect this percentage to continue to increase towards 5% or higher as we drive our strategic innovation agenda. Overall, the adjusted EBIT margin was 20.3%.

Frank Schulkes: Looking forward we intend to continue to invest in our commercial teams and capability. Coupled with the relative phasing of growth in 2021 and significantly higher material inflation and freight costs, which means you should expect a much lower even margin in the second half of the year.

Frank Schulkes: Moving on to slide nine. As you can see, we generated $179 million of net cash from operations. This was lower than the prior year with the increase in adjusted EBITDA, being more than offset by a step up in working capital. Receivables increased associated with revenue while payments increased in relation to year end CAPEX strategic product project accruals, as well as payments under the employee incentive plan. Net interest paid was $18.8 million, which was 8.2 million lower than the first half of 2020, given the lower interest rates on the group's borrowing. We paid out $29 million of cash tax and invested $44 million in CAPEX. This was obviously higher than prior years, and you should expect us to continue to invest in the business as new products are introduced adding capacity as well as gradually increasing the level of automation.

Frank Schulkes: In 2021 CAPEX is still expected to be between a 100 million and 120 million. We also invested in the business to acquisition using $85 million to purchase Cure Medical. The net debt at the end of the year was $944 million and the lease liabilities were an additional $87 million. As you can see on this slide, we have maintained our leverage around our target of at or below two times net debt to EBITDA.

Frank Schulkes: Finally, on slide 10, let me confirm the update and guidance for this year. We're pleased with the growth we have already delivered in 2021 but are aware of the relatively tougher comparatives in the second half, particularly in Infusion Care and advanced wound care and of the declining trends in Critical Care. We're also mindful of the continuing COVID uncertainty, particularly in GEM. We now expect full year organic revenue growth of between three and a half and 5%.

Frank Schulkes: Moving on to the margin guidance. We now expect constant currency adjusted EBIT margin to be between 18 and 19%. We achieved a strong first half margin performance however, during the second half we expect raw material prices and freight costs to increase significantly. On top of that, we expect higher operating expenses given the projected phasing of transformation investments and increases in sales and marketing, as things continue to normalise in our largest markets. It is important to remember that there is a currency headwind on the adjusted margin at spot rate, which needs to be factored in. Based on actuals and recent FX, our guidance at spot rate would equate to an adjusted EBIT margin of 17.1 to 18.1% as opposed to 18 to 19% at constant currency. So 19 basis points lower. Wrapping up the financial review, we've made good progress year to date and we'll remain focused on pivoting to sustainable and profitable growth. And with that, I'll hand back to Karim.

Karim Bitar: Thanks Frank, and really appreciate the summary of our strong financial performance in the first half. What I'd like to do now is to move on to slide 12 and try to give you some colour in regards to from a strategic advantage point. How are things progressing? I think the first thing to note is that we're very much staying the course and executing against our FISBE strategy. And as you will recall, our FISBE strategy consists of five key pillars. The first one is to really focus on key categories and key markets. We've identified four categories that we want to focus on. Advanced Wound Care, Ostomy Care, Continence Care, and Infusion Care. And we've identified 12 markets around the world where we're very focused on with a particular emphasis on the USA and China. Second what's important is that we innovate. And in fact, we're in the midst of going ahead and doubling our investment in R&D and we'll continue to drive our innovation agenda and I'll be telling you more about that here shortly. Thirdly, there's a whole effort to simplify. Simplify the way we work and simplify, frankly, our portfolio to reduce complexity. Fourthly, it's all about building core capabilities, in areas like sales, in areas like marketing, in areas like quality. And that's really critical that we do that. Ultimately, it's all about executing with drive and passion and ensuring that our Do:Say ratio is where it needs to be.

Karim Bitar: From an overall perspective, what I would say is that we're making progress, we're on track. And in fact, we are pivoting to sustainable and profitable growth. I think what's important to note at this point is that we have not pivoted, past tense, in the sense that we're in the middle of going ahead and transforming our business. And there's still much work to be done. Let's take a look now at each one of these five pillars and understand what kind of progress have we actually been making. Let's move on to the next slide.

Karim Bitar: When we talk about key categories in markets, I think what's important to note is that we set some priorities for 2021. In fact, there were two, one was to drive growth in the top 12 markets. And in addition to go ahead and pursue acquisitions and partnerships that could strengthen our competitive position. So, how did we do? I think it's fair to say that our growth rate in the top 12 markets has actually been double digit. So, that's encouraging. And what's also encouraging is that we continue to focus our investments in these 12 markets. But nevertheless, we've tried to strengthen our competitive position.

Karim Bitar: So for example, we acquired Cure Medical, Cure Medical being a developer and producer of intermittent catheters in the US, which is a very large market on a global basis. And this has allowed us to go ahead and catapult to the number two position in the intermittent catheter segment in the United States. What's also noteworthy is that this acquisition is very complimentary from not only a product offering perspective, but also it's complimentary in the sense that its strengthens our sales, marketing and distribution capabilities in the continence care market in the United States.

Karim Bitar: In the area of advanced wound care, we did not pursue an acquisition, but in fact, we pursued a strategic partnership with RLS, RLS being a Swedish medical device company. And we've agreed with them to go ahead and actively market ChloraSolv. ChloraSolv is a very gentle yet effective wound debridement treatment and is part of a wound debridement protocol. And so as you think about the entire wound hygiene protocol, what's important to note, it's very complimentary to all of our efforts in advanced wound care. We can leverage our commercial presence in Europe and we'll be looking to launch and market this product in 2022. But in addition, we'll be collaborating with the folks at RLS. We'll be taking the lead in developing and pursuing development and approval in other key markets such as in the United States in the future years to come. So clearly we're staying focused on the four categories and on the 12 key markets. Let's take a look now at what's happening on the innovation front. So let's move on to slide 14.

Karim Bitar: On the innovation side, we've been trying to go ahead and strengthen our capabilities, but also to move our pipeline along. We've made significant investments in competencies, such as process development, clinical development, and regulatory, and these are getting stronger and they're critical to be able to move our pipeline forward. What's very exciting is that we've launched our innovative, extended wear infusion set in Europe. This is a seven-day infusion set and has significant benefits to patients, but also clinical benefits, frankly also. And so providers are very excited about this along with the patients. When you look at this new launch that we have, it's a very innovative and differentiated product offering. We've launched it already in Belgium and Finland. And the initial reaction from customers is actually very positive.

Karim Bitar: Now beyond the seven day or up to seven day, I shouldn't say extended wear infusion set that we've launched in Europe, I should also highlight that we have secured a 510 K from the FDA and that we're planning on launching this offering in 2022 in the United States, also, in collaboration with some of our key partners and customers.

Karim Bitar: Lastly, when you start thinking about the future outlook, we're trying to move along our pipeline, I think what's important to note that in Infusion Care, in 2022, we anticipate launching again, a differentiated and innovative, frankly, infusion set in collaboration with Tandem Diabetes for their t:sport offering, which is a very compact offering for this glycemic control segment. In the area of advanced wound care, we're planning on launching ConvaFoam in 2022 and Avelle 2.0 in 2023. In Continence Care, we're going to try to leverage our FeelClean technology and basically offer it in a compact version or form. We'll be doing that for males in 2022 and for females in 2023.

Karim Bitar: And then lastly, in the area of Ostomy Care, we're going ahead and actively developing a new offering Esteem 2.0, which is really designed to be a one-piece convex offering. And that's one of the largest segments and fastest-growing segments. And we think that our offering will be highly compatible in the marketplace. So again, very, very exciting the developments and progress we're making on the innovation front. And in due time, you'll be able to hear more about this. So let's take a look at the whole effort around simplification. How are we doing there? Let's move to the next slide.

Karim Bitar: On simplification, I think what's important to highlight is that as we've introduced our new operating model, we have become more customer centric, we've been improving accountability, but we continue to work on the whole element of pagility. And so what we've been trying to do, for example, is to migrate some of our core activities in Finance, HR, IT, and Legal into Global Business Services. In 2021, we've been focusing on doing that in the area of Finance and IT, and so we've expanded our Global Business Service center in Lisbon. We've got over 150 people now working there.

Karim Bitar: And what they've been basically doing is doing an outstanding job of taking processes, for example, in finance, like purchase-to-pay or order-to-cash or record-to-report and streamlining these processes, but also driving efficiency by introducing new technologies. And so, for example, in the area of order-to-cash, we've actually introduced robotic process automation leveraging AI, and then we were able to actually match customers with the cash we're receiving and make very, very few errors and do that in a very speedy manner.

Karim Bitar: Beyond GBS, frankly, we continue to try to reduce complexity. So for example, in the area of Ostomy Care, we're on track, frankly, to reduce about another 300 SKUs during the course of 2021. So clearly we're focused on our four categories in 12 markets, we're driving the innovation agenda, we're trying to simplify the way we operate, but also we're trying to go ahead and build capabilities. So let's try to take a look at the next slide and see how we're doing there.

Karim Bitar: On building capabilities, our priorities were to leverage some centers of excellence that we had sort of stood up last year, but also established some new ones. But let's focus on the ones that we've already established, particularly the Salesforce Excellence Center of Excellence. What's terrific about this Center of Excellence is that we've introduced both in Europe and North America, one single new customer relationship management platform. It's been very well received by our customer-facing personnel. They find it easy to use, simple to use, and frankly it's improving their ability to target key customers and frankly drive also the productivity of our commercial organisation.

Karim Bitar: On the marketing side, we've now stood up our Marketing CoE. It's still a nascent center of excellence, but we are building out digital capabilities, which will help us improve our ability to interface with customers, whether those be clinicians, patients, or consumers. And what about the next element of our FISBE strategy? Execution, how are we doing there? Let's move on to the next slide.

Karim Bitar: In terms of executing with excellence, what I'm pleased to say is that we really are embedding the execution excellence methodology at ConvaTec. The transformation execution office now reports directly to me, and that provides frankly Frank and I with a high degree of visibility in terms of the portfolio of initiatives that are critical to our success and frankly provides visibility to the entire executive leadership team. To give you a sense of these 100 plus initiatives that we have ongoing, for example, in quality and operations, we've been trying to optimise our distribution footprint in areas like Europe, in areas like the global emerging markets, really with the intent of improving efficiency, but also the quality of the service. And that's exactly what we're being able to achieve in the marketplace.

Karim Bitar: Second in the area, for example, quality, we've got scrap initiatives, scrap initiatives in Ostomy Care, in Infusion Care at the relevant sites. And so that's helping improve quality, but also drive efficiency. Other initiatives might be, for example, in the area of how do we interface with customers and how do we drive medical education? So we've been very aggressive on the digital front. We've really embraced the hybrid world. And so through our ConvaTec Academy of Professional Education, we've actually trained over 130,000 healthcare professionals. And again, we get feedback from these healthcare professionals, which helps us continually improve the performance and quality of the education we're providing them with.

Karim Bitar: Okay, at this point, why don't we try to summarise and better understand what are the prospects for ConvaTec moving forward? I think what's fair to say based on Frank's description and the numbers is that we had a strong financial performance in 2021 during the first half. In fact, we grew our revenues organically at 7.4% and we grew our EBIT in double digit. Now this was obviously supported by some softer comparatives. What's important to note though, is that we invested in a strategic transformation and we've been, and continue to be a highly cash generative business. And we've redeployed those funds into our business.

Karim Bitar: When you look at it from a strategic vantage point and you look at how are we executing against our FISBE strategy, I think what becomes clear is that we're very much on track and in fact, we're pivoting to sustainable and profitable growth. I think what's important to highlight though, is that we've yet to be able to make the claim that we have pivoted or past tense to sustainable and profitable growth. So there's still a significant amount of work to be done to bring our transformation to completion, but we're well on our way.

Karim Bitar: In terms of outlook for this particular year, what I would say in 2021, we anticipate our organic revenue growth to be between 3.5% to 5%. We anticipate that our constant currency even margin will be between 18% and 19%. And maybe most importantly, I'm comfortable telling you that my level of confidence in terms of ConvaTec's growth prospects remains high. At this point, what I'd like to remind all of you is that we're actually going to have a live Q&A at 11:00 AM on British summertime. And we'd welcome any questions that you may have. Thanks again, and look forward to being able to connect with you very soon.

Karim Bitar: Good morning, and welcome to everybody. And thank you very much for joining us. I hope you've all had a chance to view our presentation that was published this morning at 7:00 AM. What we'd like to do now, Frank and I is just to provide you with a brief overview of how we've been performing both financially and strategically, and then maybe jump right into questions. Hopefully you'll be able to see that we've had a strong financial performance in the first half of the year. In fact, we grew our organic revenue by 7.4% and our EBIT actually went ahead and grew by 17%. So I think it's fair to say that top line grew well, bottom line grew well, and we were highly cash generative and went ahead and invested in our business.

Karim Bitar: On the strategic side, I think we're very much on track in terms of executing our FISBE strategy. And we're in the midst of pivoting to sustain more profitable growth. I think it's fair to say that we've not pivoted, past tense, and we're in the midst of pivoting to sustain more profitable growth, and there's still significant amount of work to be done. Having said all that, I remain optimistic on the growth prospects for ConvaTec. When you look at the whole year for 2021 and we've gone ahead and updated our guidance, and we've got to have an increased the guidance in terms of revenue from about 3.5% to 5% on the top line. And we frankly tightened the EBIT margin to 18 to 19%.

Karim Bitar: I think at this point, what I would say is fundamentally, when you look at the longterm prospects for ConvaTec, we continue to compete in a very attractive market. And at the same time our competitive position is strengthening. And once again, what I would reiterate is the point that our longterm growth prospects are very robust. On that note, I'm going to open it up for Q&A. I would kindly ask you to please limit your questions to two questions. We have quite a few people on the line and just to be fair to everybody, that would be very helpful. At the end of the session, Kate Postans will go ahead and close us out with some closing remarks. On that note, I'm going to open it up for questions.

Operator: Thank you. If you'd like to ask a question, please signal by pressing star one on your telephone keypad. If you're using a speaker phone, please make sure your mute function is turned off to allow the signal to reach our equipment. Again, that is star one to ask a question. We'll pause just for a moment to allow everyone the opportunity to signal for a question. Thank you.

Operator: We will now take the first question from Patrick Wood at Bank of America. Please go ahead.

Patrick Wood: Perfect. Thank you. I love the new format by the way. Two questions please. The first one, thanks for flagging the skew rationalisation in Q4 for ostomy. I guess, do you think that by the end of this year, you'll be, I don't mean done in a negative way, but sorted in terms of skew counts and geography? Do you feel like the base exposure of the core business will be at the start of '22 in the place that you want to, or do you foresee a little bit more in terms of adjustments?

Karim Bitar: Yeah, I think, Patrick, we're making good progress on the skew rationalisation. I would anticipate that we'll probably meet also at 2022, frankly, to be able to frankly drive 80% plus of the skew rationalisation. So we're making good progress, but it will go into 2022. So I think realistically, we should be thinking, once we hit 2023, we should have done the vast majority of the skew rationalisation.

Patrick Wood: Very helpful. Thank you. And then second question, and I'll jump back in the queue, the guidance and outlook on the short term, but the guidance implies that the H2 OPEX in totality, including COGS is up sort of 100 million relative to H1, which seems quite high, even with the cost inflation. And if it is cost inflation and FX, can you put pricing through to help offset that because isn't there a risk to the 2022 margins, a flat to down versus 2021 if you've exited the year with those incremental costs and they end up eating off the benefit of the transmission costs rolling off has next year? I guess, that exit rate in H2, maybe help us understand what the implications are by exiting quite a low margin number on that way. Thanks.

Karim Bitar: Frank, do you want to take that second question...

Frank Schulkes: Sure, sure. Yeah. Yeah. So first of all, I don't think it is 100 million. It's, I think a lot less, but let me explain. Indeed, we're expecting a very significant reduction in the EBIT margin from the first half to the second half. And there are several elements to this. As we also explained, clearly a very significant increase in material inflation, as well as trade costs, which we believe is going to be temporary. There is no structural reason why this would stay, but for sure, that is a very significant headwind in our '21 outlook and specifically in the second half.

Frank Schulkes: Second, indeed, there is a step-up in operating expenses as well for several reasons. First of course, is the phasing of our investments in sales and marketing in the emerging markets, in R&D, in innovation, in IT and digital, which is the majority. And then second, we're also starting to see some COVID normalisation. As you perhaps remember last year, we had a tailwind because there was less spend related to COVID influencing T&E as well as NANSP. And we start to see a clear pickup. So we expect that in the second half, that will be sizeably higher than in the first half. And then of course you have the usual merit, those type of things. So overall we're expecting, you can do the math, it's coming in at 20% for the first half. Our guidance, 18 to 19% in constant currency for a total year assumes that, but I don't get to 100 million. It seemed like it was a lot less.

Frank Schulkes: Now coming back to what can we do short term? It is very tough short-term to really drive prices up to counter this. As I said, I don't think these inflationary impacts are structural. We believe they will eventually get much closer to pre-COVID levels. At the same time of course, we're looking at pricing not so much in a short-term response but more longer term, and believe I think done a good job in the last 18 months getting much better at pricing from a strategic positioning, but also from a discipline point of view. And then the final thing here is of course we will continue to drive productivity to try to offset these inflationary pressures. I hope that answers your question, Patrick.

Karim Bitar: Okay, let's go on to the next question. Thanks Patrick.

Operator: Thank you. We'll now take the next question from Paul Cuddon at Numis Securities. Please go ahead.

Paul Cuddon: Hi guys, just two questions please. So the Opex investment percentage of sales has gone from 37.2 to 38.2 for H1 21. Just wondering if you could quantify how much of that is just an FX impact, verses actually putting more feet on the ground in line with the increased sales and marketing investment that you aspire to. And then just secondly, the guidance that you've given for the year, is it possible to quantify how much caution and hesitancy you've put in there with regard to potential future restrictions in winter 2021? Thank you.

Karim Bitar: Thanks, do you want to take it.

Frank Schulkes: Yeah, sure. So the impact of foreign exchange in dollar terms is of course pretty sizable, I would say 50% or so of the increase is related to foreign exchange increases. Because we've seen a significant uptick in Euro, in British pound, which is of course, those are pretty heavy OPEX centers for us.

Frank Schulkes: However, in terms of percentage of sale, the impact is smaller because of course there is also an impact on the top line. We've seen also a lift, something like 400 basis points or so, in top line because of foreign exchange. So therefore in terms of percentage of sales, the impact is relatively small; in terms of absolute dollars, it's probably around 50%.

Paul Cuddon: Thank you.

Frank Schulkes: Then on guidance portion. Listen, if we look at the full year and we've been very clear about that, clearly the second half comparators are a lot tougher if you compare to the first half specifically wound. First, we've seen last year a double digit increase between the first half and the second half.

Frank Schulkes: Second, the infusion care businesses is also of course facing quite some tough comparators. Last year in Q3, we had 27% growth in the market, that is probably higher single digits, somewhere between 6% and 8%. So you can expect a very different profile for our business. And don't expect any stellar performance in Q3 because of those specific items.

Frank Schulkes: And then indeed there is a level of caution here, given that the emerging markets, we've done very well in commercial execution, leadership changes, focus on in market demand, professional education. But on top of that, we've also had some pill wins in terms of for instance government funded programs.

Frank Schulkes: And we've seen lately, again, a resurge of COVID lockdowns. Japan is completely locked down. ANZ I think is at this moment in 60% lockdown. We see pretty challenging environments still in Latin America. And therefore we are a little cautious. I don't want to put a number on it, but we are a little cautious for our second half given these uncertain circumstances in one of our key growth engines of the business. But I really don't want to put a specific number on it.

Paul Cuddon: That's much appreciated. Thank you.

Frank Schulkes: You're welcome.

Operator: We'll now take the next question from Hassan Al-Wakeel at Barclays. Please go ahead.

Hassan Al-Wakeel: Thank you. I have a couple. So firstly, on the top line, as you think about the full year organic growth guidance, what would your expectation be from any one-off benefits you may have received this year from COVID? And how should we be thinking about more sustainable growth next year? Or is this year's growth sustainable going forward in your view?

Hassan Al-Wakeel: And then secondly, just following on margins, what was the rate of inflation you witnessed in raw materials and freight? And what mitigating activities are you implementing? And just again, trying to understand whether you'll be able to offset this as we look into 2022. Thank you.

Karim Bitar: Yeah. Let me try to give a little bit of qualitative colour to both, but then I'm going to ask Frank to probably be a little bit more quantitative. I think in terms of sustainability of the top line, I think we've been very, very clear that fundamentally the markets that we compete in are growing at 4% approximately. And then in the infusion care area, we're anticipating that end market is growing high single digits.

Karim Bitar: And so really our goal in terms of sustainability, to be able to grow the top line in constant currency at four plus percent. So really saying the minimum being, hey, we've got to at least grow with the market, if not more than that.

Karim Bitar: And I think it's fair to say that if we've been executing on our FISBE strategy, that we'll position the business to be able to do that. I think some of the business units are further ahead in that journey. And so I think if you look at the area of advanced wound care, continence care and infusion care, I think they're well on their way to that journey.

Karim Bitar: I think ostomy care, we're starting from a more further back, let's just say, from a competitive position. I think they're improving their position, but there's still a way’s to go. So I think that from a long-term sustainability position, I think that my confidence in being able to achieve that is increasing in time. And I think you see that reflected in our performance and in our outlook statement on the top line.

Karim Bitar: In regards to the inflationary pressures that we're getting. We proactively do manage prices, and earlier question about price, and so we look at price strategically and tactically, we have a pricing center of excellence. And frankly, that center of excellence is delivering.

Karim Bitar: Also qualitatively in terms of productivity, we have an entire productivity effort, both in quality and operations, which we're driving aggressively and is providing outputs. And that's really driven by the transformation execution office and a whole series of interventions.

Karim Bitar: And along that, frankly, looking at the whole area of G&A and through global business services for that, being HR or finance or IT or legal, looking to get and drive efficiencies there. That's how I would describe the two qualitatively, but maybe I'll let Frank jump on in and provide a little bit more colour.

Frank Schulkes: Yeah, I think related to sustainable growth, I think Karim you said it all, clearly the COVID benefit, well, COVID clearly has distorted a lot of the growth rates. And that is more a function of what happened last year than this year with one exception. And that might be in critical care. But we've seen the big double digit growth rate in the wound business for instance in the first half.

Frank Schulkes: If we strip out COVID and some other phasing or de-stocking stocking activity last year, this year, we believe that business grew around 4% to 5%. So, that gives you the idea how distorting the COVID dynamic is.

Frank Schulkes: And the other business where we have seen quite some movement related to COVID is of course the critical care business, which typically grows below mid single digits, so low to mid single digits, has been growing 17% last year. And we expect that that business still had some benefits in the first quarter, going back to your question, because it grew 7% or so. But we have now started to see that business dip into the negative territory. And that is again a function of that huge demand in ICU products that was extraordinary last year.

Frank Schulkes: So again, COVID has introduced a certain I would say variability in the quarter over quarter, year over year type performances. But largely related to last year.

Frank Schulkes: Now related to pricing, Karim has said, and I mentioned it before as well I think in answering Patrick's question, we're managing price through pricing COE, more discipline, more transparency, training and those type of things. We have opportunities to respond short-term, but they are relatively limited. And where we can, we of course are raising prices as a result of the fact that for instance materials, specifically resin prices, have increased. So where possible we are responding very tactically. But it is to a certain extent limited what we can do in the short term.

Frank Schulkes: And as I said in the long-term, first of all, I think these prices will start to normalise or at least come back closer to pre-COVID levels. When exactly, tough to estimate. We don't expect that to happen in '21.

Frank Schulkes: And then final comment here, of course long-term we have more opportunities to do something about the pricing, but we are also driving productivity to offset these type of temporary pressures.

Hassan Al-Wakeel: That's very helpful. And if I could just follow up on that. Based on what you see today, I mean, is it still fair to assume that 2022, you should see margin expansion over 2021?

Frank Schulkes: Well, again, I don't want to get into 2022 guidance here, but the way you have to think about it is as follows, coming back to what Karim said. We're investing here to pivot to sustainable and profitable growth, to get us growing in line with the market or better than the market. And that is our first and foremost focus and priority.

Frank Schulkes: And then we expect to see a gradual improvement in the margin rate over a extended period of time. That's how you have to think about it. Again, I don't want to get into '22 specific here, but expect that four, four plus percent growth rate, and then a gradual improvement in EBITDA margin over time.

Hassan Al-Wakeel: Thank you.

Karim Bitar: I would just add to Frank's comment to say, if you're trying to understand the overarching financial picture we're driving for is top-line growth of four plus consistently. I think in terms of the bottom line and the EBIT margin, I think it's realistic that in the short term timeframe period, you'll be hovering in the low twenties. And I think from a long-term structural perspective, if you said is there anything limiting us from being able to get into the mid twenties? I think the short answer is no structurally. So hopefully that gives you some broad parameters to be thinking about.

Karim Bitar: I think on the balance sheet, we're looking to manage the balance sheet conservatively with a net debt to EBITDA ratio of 2.0 or less. And then frankly, we're generating significant free cash flow of north of $350 million per annum. And so we're looking to leverage that free cash flow, obviously making significant investment in the business. But then if there are inorganic opportunities to pursue bolt on acquisitions, like the care medical acquisition, it strengthens our competitive position in the four categories and the 12 geographies. We'll do that proactively and aggressively. I think you'll continue to see us do that.

Hassan Al-Wakeel: Perfect. Thank you.

Karim Bitar: Okay, why don't we go to the next question. Yep.

Operator: Thank you. We'll take the next question from Charles Weston at RBC. Please go ahead.

Charles Weston: Hello. My first question relates to gross margin. In your prerecorded presentation you indicated that the margin was up 160 basis points excluding FX. And you talked about price mix and productivity as contributing. So could you just talk a bit more in terms of the mix of those two. How much is price mix, how much is productivity? And in fact, can you even split out like for like price and the mix impact?

Charles Weston: And my second question please is around employee churn. Could you update us on what that stands at on the planned and/or unplanned basis? Thank you.

Karim Bitar: Okay. Sure.

Frank Schulkes: I will take the first one, Karim, yes?

Karim Bitar: Yes.

Frank Schulkes: Indeed we had an increase in our gross margin excluding foreign exchange. And in price mix, we saw a positive impact year over year, specifically in mix. And of course mix is a culmination of the different growth rates between the different business units, but then also the growth rates of brands within the business units, any geography type of mix. And that was a very material driver of that first half growth margin improvement given the trends that we saw in the different brands and the different businesses.

Frank Schulkes: I really can't go too far in this because I don't want to provide too much competitive information. But mix was a material positive impact.

Frank Schulkes: And second, we have continued to deliver growth productivity programs as part of our transformation, which really started in 2019. And that's continued to deliver a steady stream of positive productivity. Of course, we have then the usual headwinds like labor inflation, usual material inflation. As I said, the majority of that additional hike in material inflation will come in the second half, and additional depreciation.

Frank Schulkes: But it was a combination of positive mix, very I would say modest pricing and productivity. And I would say the mix was probably the biggest contributor of that total package.

Karim Bitar: Thanks, Frank. Yeah, look, on the employee turnover, what I would say is that from an overarching perspective, the level of engagement across the organisation has improved significantly during the course of the last couple of years. We do measure that through an index, which we call the organisational health index. We measured it back in the spring of 2019 and we measured it back again in the fourth quarter of 2020. And there were some very, very significant improvements in terms of level of engagement and motivation and practices that we were trying to encourage such as, say, being more customer focused, being more execution oriented.

Karim Bitar: To your specific question though which was, what about turnover? We look at turnover in terms of voluntary turnover and involuntary turnover. And obviously we focus particularly on voluntary turnover. That number has been coming down, but during the course of the last 12 months it has stabilised. And right now it's running at about 8%.

Charles Weston: Thank you. Could I just follow up please on the price point. What is like for like price negatives year on year for the first half? And is that mix effect that you talked about structural, i.e. is that all the various different mix components you talked about something that's likely to be continuing for the remainder of this year and next?

Frank Schulkes: So price basically was very modest as I said, very modestly positive in some areas and modestly negative. We expect a little bit more price erosion in the second half, specifically in the wound business. Because for instance as an example, we are going to see the full impact of the French reimbursement cut in foam. Foam is the biggest segment within France, so that is going to be putting some additional pricing pressure on the business in the second half. So price was really net net, not of any significance.

Frank Schulkes: Mix, if you say, mix is that sustainable, mix is very tough to forecast for it because as I said, it's a combination of differences between business units and brands within business units, sub brands, and then also regional mix. So that's very tough for me to answer. Clearly, we try to manage it as good as we can. But in the end, market demands and determines the majority of that.

Operator: Thank you. We'll now take the next question from Michael Jungling at Morgan Stanley. Please go ahead.

Michael Jungling: Thank you and good morning, all. I have two questions, please. Firstly, on new product launches, can you comment on what we can expect? Sorry, my other phone has rang. What we can expect with respect to new product launches in ostomy and in wound over the next 12 months. And then secondly, on the Salesforce expansion, can you comment on China, on what progress you've made in hiring salespeople? And if you don't want to give the numbers or the increase, perhaps some sort of index increase and how that compares to 2019.

Karim Bitar: Yeah. So hi, Michael. So look, in regards to new products in the wound and ostomy care, we're anticipating launching ConvaFoam in 2022 and about 2.0 in 2023. In ostomy care, we're anticipating launching the Esteem 2.0, which is a one-piece complex offering in 2023. So that's what I would say on new products. I'd say overall, across all four of the categories we're competing in, there is movement on the pipeline. Incontinence care went and has been launching. GC Air male in 2022 and GC Air female in 2023.

Karim Bitar: This uses our proprietary fuel clean technology, but we're looking to basically offer it in a compact format. And then also Infusion care, there's more developments in coming about, particularly with extended wear and fusion testing launched also in the United States next year. And then also, with the whole development effort that we had with tandem diabetes in terms of their T sport new offering, which is a very compact and innovative offering for the smart question that controls segments. And we've got very differentiated infusion sets that we've developed for this particular application. That's a little bit on new products. On Salesforce expansion in China, look, when I looked at how it is that we're investing heavily in China, it's a very significant increase in the number of folks on the ground. But what's important to highlight is that our approach to China has been not purely seen on the street. It's very targeted in terms of what are the key hospitals and medical centers in China we want to focus on?

Karim Bitar: So we have those very clearly identified. And then B, frankly, we're really focused on how do we interface with customers in a digital manner? So we've made heavy investments there in terms of digital interface with clinicians. So you look at, for example, the ConvaTec Academy of Professional Education, where we trained over 130,000 healthcare professionals, many of them in China. You look at our E-commerce platforms, banking Hodson care. Approximately a third of our revenue there is being generated on E-commerce platforms. So I think the bottom line is that it's a significant investment that we're making, and we'll continue to grow and invest in the global emerging markets. And I think China will continue to be important for us.

Michael Jungling: Yeah, to briefly follow up on the China Salesforce expansion.

Karim Bitar: Mm-hmm (affirmative).

Michael Jungling: Are you getting the productivity that you thought out of these investments? Are they delivering the speed of sales growth, speed of sale you sort of expected?

Karim Bitar: Yeah, I think the short answer is yes. Mm-hmm (affirmative).

Operator: Well, we'll take the next question from Ed Ridley-Day at Redburn. Please, go ahead.

Ed Ridley-Day: Good morning. Thank you. A couple of follow-up questions, please. First, on ostomy, just a detail, which European markets were particularly soft? And any particular reason for that, or was it just more COVID disruption ongoing? But clearly, it would appear that your underlying ostomy growth is moving very much in the right direction. And secondly, also I had a question on the extended use sets. Obviously, great to have FDA approval there. Can you help us? First of all, was there much benefit from the European approval in the first half? And how should we think about the impact on your infusion business in the second half from those approvals?

Karim Bitar: Yeah. So what I would say is on the ostomy growth, we're making progress, particularly in global emerging markets where we saw significant growth. We're strengthening our commercial execution in the United States. And I think that when it comes to Europe, I think the reality is that it's a very competitive marketplace. And so really, when you see our varied performance in Europe, it's really more a reflection of our historical competitive position. So in some markets, such as Italy and Poland, where we performed well, we're continuing to bolster that. But in other markets I'd say, which is Germany and the UK, we continue to be challenged. And so we're intervening from a commercial perspective in terms of improving our commercial execution. But I think that that's still going to take some time, frankly, to bear fruit is what I would say on ostomy care. So more of... the European performance fundamentally is more of a function of our ability to execute and our historical competitive positions, is what I would say.

Karim Bitar: On the second question, which was extended wear infusion sets, how much did we benefit in Europe? Up to this point, very modestly, frankly. We've launched in a few geographies, such as Belgium. So we're just starting with that. And then in terms of the extended wear infusion sets that also will be launched in the United States, I think all of these sort of take time to materially impact us. So I think it's fair to say that we're in the midst of launching in Europe. We will be launching next year, but we've not seen as of yet any material impact to our financial performance. I think we will see that during the course of the next couple of years.

Ed Ridley-Day: No, that's fair. Thank you.

Karim Bitar: Mm-hmm (affirmative).

Operator: We'll now take the next question from Christoph Gretler at Credit Suisse. Go ahead.

Christoph Gretler: Thank you, operator. And good morning, Karim, Frank.

Frank Schulkes: Hi.

Christop Gretler: I actually have...

Karim Bitar: Good morning.

Christoph Gretler: Hi. Two questions now, first on wound care. I think in your prepared remarks, you mentioned that that was performing ahead of your own expectations. Could you maybe elaborate to know where that has been placed in particular? And my second question is relating to your emerging market business. I think you called out strengths in Latin America and Asia. And obviously, as a skeptical analyst, to be always a bit y'know, I'm curious in these markets. There is a lot of opportunity with respect to distributor stocking effect, et cetera. Could you maybe provide a bit more comfort about the sustainability of these growth rates? That will be great. Thank you.

Karim Bitar: Frank, do you want to take the advanced wound care one, and then I'll take the question on sustainability of top-line in GEM?

Frank Schulkes: Yes, I will. So good morning, Christoph. So the wound performance was indeed somewhat ahead of our expectation. And I think, clearly, one of the reasons for that was the growth engine emerging markets has been performing very well in the first quarter as well in the second quarter and helped as well by a pretty speedy recovery specifically in the US in the second quarter. So those two elements have been helping and therefore, we are a little ahead of expectation, related to GEM, if you think about the success of the emerging markets that we have, first of all, Latin America has been already for some time a very stable growth driver for us with a terrific leadership team there.

Frank Schulkes: And a couple of years ago, we also brought in a new leader for GEM, Supratim Bose, who has hired a new team for the Asia Pacific region, has really focused the team away from dealing with distributors and creating in-market demands. The team has very much focused on also creating brand equity by creating a professional adaptation muscle in the first half, and I think Karim mentioned that in the presentation. We basically trained over 130,000 professionals in the healthcare market and in the emerging markets. And then the last thing here is what we've done specifically in China is developing the E-commerce platform. So there are a lot of pillars I would say that are foundation of that growth in the emerging markets. Coming back to your question related to distributor stalking, I think that comes back to what I just said. We're very focused on in-market demand.

Frank Schulkes: We know what the inventories are over our distributors, and we're, of course, closely following that and working with them. So I think there was a good level of confidence because it is managed, that there is the right level of transparency, and again, the right level of focus on in-market demand creation with our team. Now, about sustainability, our expectation is that the emerging markets will continue in the medium and long term to be an important growth engine for ConvaTec. Of course, not every quarter will be the same type of growth. There will be some volatility. I already mentioned some of the COVID related dynamics that proceeded in the second half, for instance. So we expect that the growth in the second half will be different than the first half, but you got to look at this more sort of through a lens of a longer horizon than just one quarter or two quarters. And with the investments and the change that I've just described, we believe we have the right set up here to continue to drive a very strong growth in emerging markets.

Christoph Gretler: Okay. Thank you. I appreciate your comments and have a great weekend, everyone.

Frank Schulkes: Yeah... thank you.

Operator: We'll now take the next question from Christian Glennie at Stifel. Please, go ahead.

Christian Glennie: Hi, guys. Thanks for taking the questions. A couple of questions relate to R&D and the impact there. I think in your prepared remarks early, you talked about a doubling R&D investment. I just wanted to clarify in terms of what that timeframe... Is it related to sort of last year and kind of the doubling? And what's the timeframe there? And there was some related comments around sort of moving into 5% sales and/or above, just for context and clarity on that side of things. And then secondly, in terms of the... you laid out quite a few new product launches across some of your divisions coming over the next few years. In terms of just thinking about the impact of that, is it more about supporting that 4% plus top line number, or could it be accreted to that to be expecting a bit more of an acceleration of that growth based on those sort of pipeline products coming through?

Karim Bitar: Yeah, I think on the first one, on the doubling, really, if you look at a reference point back in 2018, 2019 timeframe period, right? Relative to approximately the, let's call it 22, 23 timeframe period. I mean, roughly, that's going to give you a sense of the doubling, right? So it is a very significant step up, and then Frank can comment more precisely. But really, what we're focused on is less, "Hey, here's a percentage of sales. Here's an absolute number." Fundamentally, what we look at is, is there an unmet need in the marketplace? Do we believe we can develop and successfully launch a differentiated solution? In seed, we believe that we can deliver and develop an intellectual property position. If those three elements are met, then what we do is proactively manage our portfolio. And we very systematically review the portfolio across, frankly, the core categories we're in, across the adjacencies.

Karim Bitar: And then we look at the innovation pipeline, both from an organic vantage point, but also from an inorganic vantage point, right? So it's a very sort of systematic approach to we're thinking about the innovation engine. In terms of a potential impact, I would say that the launches that I highlighted to all of you, I think at a minimum, they should underpin the four plus because, frankly, innovation and R&D is the lifeblood of being a med tech company and particularly for ConvaTec. And so we need to ensure that. Could we do and go above and beyond that? I think time will tell, frankly, Christian. And so I think there's a range there. And so the minimum is to bolster and ensure credibility behind the four plus. And then the question is, is it four? Is it the plus? And I think frankly, time will tell. Frank, did you want to add anything?

Frank Schulkes: So I think impure, numerical forms and just give you a little bit of a historical perspective. A couple of years ago, R&D as a percentage of sales was two and a half percent. And we're now in the 4% range. So we are clearly investing. We're investing in capabilities and also in programs and drive. That's sort of what we call velocity of innovation up in the company that will then yield in a family of product introductions in the future. So it gives you a little bit of numerical examples, where we came from and where we are today and where we're going.

Christian Glennie: Okay. Thank you. That's helpful.

Frank Schulkes: You're welcome.

Operator: Once again, to ask a question, please press star one on your telephone keypad. If there's no further questions at this time, Kate Postans, I'd like to turn the conference over to you.

Kate Postans: Thank you. I really just want to finish by reiterating our thanks to everyone for dialing in and showing an interest in ConvaTec. If you do have any follow up questions, please don't hesitate to reach out to me. And I hope everyone has a good day and a nice weekend. Thank you.

Frank Schulkes: Thank you.

Karim Bitar: Thanks, Kate. And I just want to thank everybody on Frank and I's behalf. We really appreciate the interest in ConvaTec, and we'll be in touch.