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Coloplast A/S (CLPBY.DK)

Q3 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the Coloplast Interim Financial Statements for 9M 2021, 2022. Throughout the call, all participants will be in a listen-only mode, so there's no need to mute your individual lines. And afterwards, there'll be a question-and-answer session.

With that, I will hand the floor to our speakers. Please begin your meeting.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

Good afternoon and welcome to our Q3 2021, 2022 conference call. My name is Kristian Villumsen and I'm the CEO of Coloplast and I'm joined by our CFO, Anders Lonning-Skovgaard; and our Investor Relations team. To start, like we usually do with a short presentation by Anders and myself and then open up for questions from you.

Please turn to slide number 3. In Q3, we delivered 8% organic growth and an EBIT margin before special items of 30%. We delivered a respectable return on invested capital of 26% after tax and before special items impacted by the acquisition of Atos Medical. Reported growth in Danish kroner was 21%. Atos Medical contributed 9 percentage points to the reported growth and delivered double-digit underlying growth.

Before I dive into today's results, I'd like to zoom out and put a few words to the current operating environment. The world is in a very different place from where it was just a few months ago. Inflation is on the rise globally.

Supply chains are disrupted, interest rates are rising, consumer sentiment is weakening, and we have a pandemic still ongoing in parts of the world, of course, increasing uncertainty about the macroeconomic outlook. We're experiencing some of this firsthand at Coloplast.

COVID-19 continues to impact performance in our business in China. Energy prices in Hungary, where we produce the majority of our products have gone up by around 400% year-to-date. Our collecting devices business is impacted by raw material supply shortage, just to name a few. Despite these challenges, our business is sound, and I'm very pleased with the company's performance and resilience, as we continue to take market share across all geographies. And most importantly, we continue to help a lot more people living with intimate healthcare needs globally.

Let me also provide a short update on our sustainability strategy and performance. At Coloplast, we're committed to ambitious science-based climate action, in line with the Paris Agreement. In June, our carbon emission reduction targets were approved by the science-based target initiative. This approval is a recognition that the targets across our production and value chain are consistent, with the reduction required to keep global warming to 1.5 degrees.

During the first nine months of the year, we reduce Scope 1 and 2 emissions by 15% and increased the share of renewable energy use by 8 percentage points to 71%, mostly driven by the replacement of natural gas with electric heating pumps in our Nyirbator site in Hungary. In May, we opened a second production site in Costa Rica, and here, I'm pleased to say that both of our production sites run on renewable energy directly from the grid. With ongoing projects in the US and China as well, so there's more work ahead of us, but I'm very pleased with the progress we've made so far.

Now let's go through a few highlights from our third quarter. Our Ostomy Care business posted 10% organic growth, driven by solid growth across all regions, excluding China. The US Ostomy Care business had another solid quarter and continued to grow at a double-digit rate. In the US, Continence Care, I'm encouraged by the healthy growth in new patients, which led to improved sales growth during Q3. Our Interventional Urology business delivered a solid quarter with broad-based growth of 11%.

China remained impacted by COVID-19 and developed as expected in the quarter. New lockdowns and restrictions continued to emerge, resulting in reduced hospital access and a decline in procedural volumes in the affected areas. Outside of China, our emerging markets region continued to perform well with broad-based double-digit growth. Voice and respiratory care delivered double-digit underlying growth driven by a very strong performance in the laryngectomy business and both performance and integration are on track and very satisfied with how the business is developing so far.

Today, therefore, we maintain our financial guidance for the full year. Anders will take us through the details later. But overall, organic growth is still expected at 6% to 7% and reported growth in Danish kroner is still expected at around 15%. The EBIT margin guidance before special items is also unchanged and expect it to be around 31%, an EBIT margin after special items is still expected at 28% to 29%.

Now, let's talk about the results in some more detail. Please turn to slide 4. In Ostomy Care, organic growth was 7% for the first nine months and growth in Danish kroner was 10%. In Q3, organic growth was 10% and growth in Danish kroner was 13%. Growth continues to be driven by our SenSura Mio and Brava supporting products and our SenSura and Assura/Alterna portfolios also continue to contribute to growth in emerging markets.

From a geographical perspective, all regions contributed to growth led by Europe and especially the UK, where both our manufacturer business and Charter home delivery business continued to deliver solid growth. The US also posted solid double-digit growth; both in emerging markets, excluding China was double-digit and broad-based, led by Latin America. Growth in China was flat in the quarter, as expected due to the negative impact that COVID-19-related restrictions had on procedure volumes and access to hospitals.

In Continence Care, organic growth was 6% for the first nine months and growth in Danish kroner was 9%. In Q3, organic growth was 5% and growth in Danish kroner was 9%. Growth continues to be driven by our SpeediCath ready-to-use intermittent catheters with good contribution from the SpeediCath Flex portfolio, as well as our SpeediCath standard and compact catheters.

Growth in the quarter was negatively impacted by back orders in our collecting devices business, due to supply shortages experienced by raw material supplier. Production and sales resumed during the quarter, however, at reduced capacity due to continued supply uncertainty. The back orders and collecting devices are expected to persist into Q4.

From a geographical perspective, all regions contributed to growth driven by Europe and especially the UK. Major markets also contributed to growth, driven by Latin America. In the US Continence Care business, growth began to improve driven by the normalization of growth in new patients, towards the end of Q2. The improvements in sales growth has been slightly slower than expected, but the healthy underlying patient growth gives me confidence that sales growth will continue to pick up.

In Interventional Urology, organic growth was 8% for the first nine months and growth in Danish kroner was 13%. In Q3, organic growth was 11% and growth in Danish kroner was 19%. Growth in the quarter was broad-based, the Endourology portfolio was the main growth contributor with solid performance across all regions.

The US Men's Health business made a solid contribution to growth, as well, driven by the Titan penile implants. In Wound & Skin Care organic growth was 7% for the first nine months and growth in Danish Kroner was 11%. In Q3, organic growth was 5% and growth in Danish kroner was 10%. The Wound Care business grew 7% organically in the first nine months and 4% in the quarter. Biatain Silicone portfolio was the main growth contributor and both in Biatain Fiber also continues to perform well and contribute to growth.

From a geographical perspective, Europe was the main contributor to growth driven by Germany and the emerging markets, excluding China, also contributed very nicely to growth. As expected, sales in China declined and continued to be impacted by COVID-19 and the limited hospital access in the affected areas. The complete contract manufacturing business also made a solid contribution to growth in the quarter. Voice and respiratory care contributed 5 percentage points to the reported growth in the first nine months, reflecting five months of impact and 9 percentage points in the third quarter.

The underlying growth for voice and respiratory care in the quarter was double-digit driven by the laryngectomy business. Laryngectomy delivered solid double-digit underlying growth, driven by an increase in the number of patients served in existing and new markets, as well as an increase in patient value driven by the Provox Life portfolio. All regions contributed to growth led by Europe. Tracheostomy and ENT business also contributed to growth and grew mid-single digit in line with expectations.

With this, I'll now handover to Anders, who will take you through the financials and outlook in more detail. Please turn to slide 5.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

Thank you, Kristian, and good afternoon, everyone. Reported revenue for the first nine months Increased by DKK 2.2 billion, or 15% compared to last year. Organic growth contributed DKK 972 million, of 7 percentage points to reported revenue. Acquired revenue for the first nine months contributed DKK 773 million to reported revenue, of which DKK 757 million were related to the Atos Medical acquisition. Acquired revenue contributed around 5 percentage points to reported growth in the first nine months. Foreign exchange rates had a positive impact of DKK 450 million or around 3 percentage points on reported revenue due to the appreciation of mainly the US dollar, British pound, Chinese yuan against the Danish kroner.

Please turn to slide 6. Gross profit for the first nine months amounted to around DKK 11.4 billion, corresponding to a gross margin of 69% against 68% last year. The gross margin was positively impacted by leverage on production cost and efficiency savings from the Global Operations Plan 5. The inclusion of Atos Medical and price increases also had a positive impact on the gross margin. On the other hand, the gross margin was negatively impacted by double digit wage inflation in Hungary, increasing raw materials, energy and transportation prices, as well as ramp-up costs at our volume sites in Costa Rica. The gross margin includes positive impact from currencies of around 30 basis points.

Operating expenses for the first nine months amounted to around DKK 6.3 billion, an increase of around DKK 1.2 billion or 23% from last year. Atos Medical contributed with DKK 465 million to operating expenses, of which around DKK 96 million were related to the PPA amortization, included under distribution costs. Excluding Atos Medical, the increase in operating expenses was DKK 710 million or 14% compared to last year. The distribution to sales ratio for the first nine months came in at 30% compared to 28% last year. Distribution cost increased by DKK 894 million or 22% compared to last year. Impacted by the inclusion of Atos Medical, high logistic costs, increasing seasonal marketing and travel expenses as COVID-19 restrictions eased, as well as continued commercial investments in the US Interventional Urology and consumer and digital initiatives.

The admin-to-sales and R&D-to-sales ratios for the first nine months came in at 4% of sales, on par with last year. Admin expenses increased by 33% for the first nine months, impacted by the inclusion of Atos Medical, as well as facing of legal consultancy and IT cost. R&D expenses increased by 18% for the first nine months, impacted by the inclusion of Atos Medical, as well as increasing activity levels across our business areas.

Overall, this resulted in an increase in operating profit before special items of 8% for the first nine months, corresponding to an EBIT margin before special items of 31% compared to 33% last year. The EBIT margin contains a positive impact from currencies of around 40 basis points; mainly related to the appreciation of the US dollar, British pound and the Chinese yuan against the Danish kroner. EBITDA for special items was around DKK 4.7 billion, corresponding to an EBIT margin after special items of 28%. EBIT was impacted by special items of DKK 435 million, of which, DKK 135 million of transaction integration costs related to the Atos Medical and DKK 300 million are related to the mesh provision booked in Q2.

Please turn to slide 7. Operating cash flow for the first nine months amounted to around DKK 3 billion compared with around DKK 3.3 billion last year. The negative development in cash flows was mainly due to an increase in inventories and other receivables. Cash flow from investing activities was an outflow of DKK 11.4 billion, compared to an outflow of DKK 1.7 billion last year; impacted by the Atos Medical acquisition this year and the Nine Continents Medical acquisition last year.

Excluding acquisitions, investments amounted to around DKK 733 million or 4% of revenue. As a result, the free cash flow for the first nine months was an outflow of DKK 8.4 billion, compared to an inflow of DKK 1.6 billion last year. Adjusted for the acquisition of Atos Medical and Nine Continents, the free cash flow was an inflow of DKK 2.2 billion, an increase of DKK 511 million compared to last year. The trailing 12 month cash conversion for the first nine months was 77% impacted by the increase in inventories and other receivables.

Net working capital amounted to 26% of sales at June 30, 2022, compared to 24% at September 30, 2021, impacted by increase in inventories and phasing of trade receivables. We now expect the working capital to be around 25% of sales for the full year, impacted by an increase in inventories, mostly on raw materials, where we have decided to build some additional safety stock to accommodate for potential supply chain constraints.

Please turn to slide 8. As Kristian mentioned earlier, our financial guidance for full year 2021-2022 is unchanged. We still expect organic growth to be at 6% to 7%. And the key assumptions laid out in May still largely hope. Overall, we expect continue solid performance in Chronic Care across all our geographies, excluding China, where we expect procedural volumes and access to hospitals to remain negatively impacted by COVID-19 restrictions.

Continence Care is expected to remain impacted by back orders in Collecting Devices, as explained earlier. Wound & Skin Care is still expected to deliver in line with our Strive25 ambitions of above-market growth; however, negatively impacted by COVID-19 in China. Interventional Urology is still expected to deliver in line with Strive25 ambition of high single-digit growth. We have no current knowledge of significant healthcare reforms that will impact 2021, 2022. Our report of growth guidance in Danish kroner is still expected to be around 9%, due to the positive impact from exchange rates. The Atos Medical acquisition is still expected to contribute around 6 percentage points to reported growth. In total, reported growth in Danish kroner is still expected to be around 15%.

The reported EBIT margin before special items for full year 2021-2022 is still expected around 31%, and includes around DKK 150 in amortization charges related to eight months of impact from the Atos Medical acquisition. The reported EBIT margin after special items is still expected to be at 28% to 29%, impacted by DKK 300 million in special items related to the mesh provision booked in Q2, as well as one-off transaction and integration costs related to Atos Medical of around DKK 150 million.

The gross margin for full year 2021-2022 is still expected to be around 68%. The gross margin expected to be positively impacted by operating leverage and efficiency gains through the Global Operations Plan 5, as well as price increases, currency tailwind and the acquisition of Atos Medical. The gross margin is expected to be negatively impacted by cost inflation, including a mid-single digit increase in raw material prices and double-digit wage inflation in Hungary, as well as increasing energy and transportation prices.

On raw materials, the key pressure on prices is coming from plastics and paper. The EBIT margin guidance reflects an increase in operating costs related to the resumption of the business activities as the impact of COVID-19 recedes, as well as some pressure on freight costs. Overall, I expect that operating costs will grow slightly above reported revenue growth before Atos Medical. The EBIT margin guidance also reflects additional incremental investments of up to 2% of revenue for innovation as well as sales and marketing purposes. This year we are investing incrementally in all business areas and regions with a key focus on the US Interventional Urology and digital initiatives.

We now expect our net financials to end the financial year 2021-2022 at around minus DKK 300 million including impact from Atos Medical. The blended interest rate for the debt financing of Atos Medical is around 1.25%. Our CapEx guidance for 2021-2022 is now expected around DKK 1.2 billion and includes impact from the Atos Medical CapEx as well as integration CapEx. The effective tax rate is still expected to be around 23% positively impacted by the increase deductibility on R&D costs in Denmark, which is partly offset by one-off tax payments related to the acquisition of Atos Medical.

Thank you very much. Operator, we are now ready to take questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Our first question comes from the line of Patrick Wood at Bank of America. Please go ahead. Your line is open.

Patrick Wood
Analyst, Bank of America Merrill Lynch

Q

Fabulous. And thank you so much for taking my questions. I'll keep it to two, please. I guess the first was on Ostomy, thank you for some of the comments there. I'd love if you could unpack a little bit more for us what looks like a very, very strong number with some pricing effects. How much of it was the US being strong. Is there any kind of incremental details if you could give, because it was obviously quite a big number there? And then second one, just curious have you managed to have any discussions with less through the tender nations, let's say, more the sort of annual reimbursement style countries or governments or systems, about how pricing might be able to be adjusted over the next year or two. Do you have any line of sight into the ability to get some of that cost inflation recognized in, let's call it, more the list price side of the business just to kind of help a little bit with what is a very difficult environment. Thanks.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Thank you, Patrick. Two good questions. We are very pleased with Ostomy in the quarter. It really reflects broad-based growth across Europe, EM and the US. I'll try and comment a bit on all three of them in turn, so you get a bit more granularity. So I'd say, Europe, the numbers that are coming out now on Ostomy reflects basically a fundamentally good performance, but also that the market is recovered. We see good inflow of patients, strong performance across the continent. And in particular, if I were to highlight one, the performance coming out of the UK is very strong.

In EM, it is also broad-based. There is an impact from tenders and phasing. Remember how EM looked last year, but were quite pleased. It's led by LatAm. And then finally, of course, US. And for – I can – I'm sitting here looking at a screen with a lot of names that I know on the screen. And you've heard me talk about the US and Ostomy Care many times, and you've also heard me say that once we want to place on the two GPOs, that this was a very important moment in time for the company and it triggered a significant expansion in the front line. This is what you're seeing, we've won quite a lot of business, the enlarged team is having an effect. And I'm just very pleased to see that. Of course, now we need to do a lot more of these types of quarters into the future. But it's up, it's a good start, good performance, and kudos to the Ostomy team.

To your question on pricing, you all know that if, I mean, if you zoom out, we're a company that, to a large part, lives from a reimbursement from either private or public payers. This works fantastic in a low inflationary environment. It's more complex when you've got inflation on the rise. We have seen pricing changes, Patrick, from a number of geographies driven by payers. So, UK is one. We also see payers in the US have moved on pricing. There are active dialogues with peers in pretty much all of our major markets, mostly driven through industry associations in those respective markets. So, this is very much an ongoing dialogue with the industry across the board.

You should also note that we have done a lot of work over the past year on pricing. We have told you also that this year it's going to be ASP positive for the group in an environment where we have typically guided to up to 1% negative pricing pressure, reflecting a ton of work and many different projects across the business. And we're looking to do a similar type of impact, at least going into next year. So, this is a very, very high focus area. I hope that gives you some granularity.

Patrick Wood
Analyst, Bank of America Merrill Lynch
Q

That's really helpful. Thank you. I mean on the tenders that you mentioned with a material to the total loss to the number or not particularly?

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S
A

In EM, they did matter.

Patrick Wood
Analyst, Bank of America Merrill Lynch
Q

Awesome. Very helpful. Thank you.

Operator: Thank you. Our next question comes from the line of Hassan Al-Wakeel of Barclays. Please go ahead. Your line is open.

Hassan Al-Wakeel
Analyst, Barclays Capital Securities Ltd.
Q

Thank you for taking my questions. I have three, please. So firstly, can you talk about the strength in the gross margin in the quarter and what's driving that?

Your guidance implies a significant step-down from 69%, closer to 67% in Q4. And it'd be great, if you can walk us through the moving parts here and to what extent some of this pressure you expect to persist into next year, and whether the FX tailwinds that you mentioned reverses based on current spot rates.

And secondly, could you talk about your expectation around the wage bill, particularly in Hungary, and whether this is likely to land where you expect it for this year? And if you can share some initial thoughts into next year, given the high levels of inflation. And then thirdly, could you talk a little bit about the performance in emerging markets ex-China, and the quantum of phasing benefits from tenders in the urology business? And what are you assuming for China performance for the rest of the year? Thank you.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S
A

All right. Thanks, Hassan, for your questions. Let me start with your first one, related to the gross margin development. Yes, we delivered a gross margin for the quarter in the level of 69%. Remember, we have many moving parts, impacting our gross margin and one of the ones that is a part of the impact from Atos. Now we had a full quarter of impact. We continue to see positive FX impact. We continue to see scalability and impact from the efficiencies that we are working on within the Global Operation Plan 5.

When we move into the full year, I am expecting that the gross margin will decline in our fourth quarter. So I am expecting, for the full year, we will sit with the gross margin of around 68%. And that the main dynamics are mostly the same as we have seen so far this year. But I see a further a headwind from raw material price increases of freight and energy. So that will impact us more negatively into Q4 and that will also impact us into next financial year. But for the year 2021, 2022, I still expect the gross margin of around the 68% level, as I have previously said. So that was question number one.

Let me move into question number two. As I remember, I said it was around our wage inflation in Hungary. So please remember this financial year we decided to do a significant wage inflation in Hungary, when we started the year of high double-digit number. And that's of course already included in our numbers and it's including in our guidance. We are currently evaluating wage inflation and salary regulation for next financial year and that is something we are working on as we speak. But at this point in time, I don't expect it will be at the level as we saw this financial year, but it is still something we are working on.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

A

And then, Hassan, maybe to your questions on EM, when it comes to Interventional Urology, the tenders in urology for the quarter don't significantly impact the number, even if you peel those out, we still have good double-digit growth without those tenders. And then for EM overall, for the remainder of the business, really what we were alluding to before was last year we had a tale of tenders that hit us in Q4, where we have some of that impact now in Q3 this year. But even if you control for the phasing effect, we still have very solid double-digit growth.

Hassan Al-Wakeel
Analyst, Barclays Capital Securities Ltd.

Q

That's really helpful. And if can just follow-up on that gross margin comment around Q4, I wonder if we should think about that exit rate as a sensible assumption for the first half of next year both on the gross margin, but also on the EBIT margin side given some of that weakness that you talked about.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Yeah. So now I talked about this year, Hassan, and for next year we are working on the numbers also on how we are seeing the growth, how we see the gross margin development, how we see the expenses develop into 2022, 2023. But, of course, some of the moving parts we are currently seeing on the gross margin will continue into to next year. And please remember Atos will also benefit us in Q1 until we started to include Atos from February 1.

Hassan Al-Wakeel
Analyst, Barclays Capital Securities Ltd.

Q

Perfect. Thank you.

Operator: Thank you. Our next question comes from the line of Martin Parkhøi of SEB. Please go ahead. Your line is open.

Martin Parkhøi
Analyst, Skandinaviska Enskilda Banken AB

Q

Great. Thank you very much. I just – also a couple of issue things. Firstly, also on the growth again with the 10% organic growth in Ostomy Care. Now, you have suffered a bit on the COVID front. It feels like ages now, but it seems like you – now almost all of that except for China. Could we expect to see some extraordinary growth now, I don't know for sure all the pent-up demand based on that – you may be are now behind. And then a second question, just that to have any clarity on the tenders on Russia. If you – is there any chance that you will also repeat them in the next financial year. And then just a technical question for Anders just on the electricity prices in Hungary, where you now have partly hit some of that in Q4 and Q1 next year, maybe you can review at what level that hedging has been done.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Thank you, Martin. Good questions. Our view is that what you're seeing on Ostomy Care is not pent-up demand. And we base that view on, if you will, the raw inflow of patients into the business, particularly where we have direct businesses. We can also see that in the US, that's a good correlation. But, of course, some of this is also some level of increased activity in some of these healthcare markets. But we do not see and I don't think you guys should expect that healthcare systems will structurally come out of this with a lot more capacity, if anything we have a worry across many of the geographies that healthcare systems are short on nursing staff. But it is us winning more patients. We are not expecting this to be pent-up demand.

Russia, we're still in Russia with a significantly reduced footprint. The way the Russian market works is – it's a lot of tenders through throughout the year in the different regions. We don't bid on the tenders, distributors bid on the tenders, but we are present. We're present in the country. We deliver the products into the market. We still have a reduced setup, but we're still active.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

A

Yeah. Then, Martin, your third question related to the hitches, on energy. Yes, we have hedged our energy in Hungary for this quarter and for the coming quarter. It's something we did some time ago. So it is below our – the current spot prices. So but we have hedged it to a large extent this quarter and the first quarter of next year.

Martin Parkhøi
Analyst, Skandinaviska Enskilda Banken AB

Q

Okay. Thank you.

Operator: Thank you. Our next question comes from the line of Christian Ryom of Danske Bank. Please go ahead. Your line is now open.

Christian Sørup Ryom
Analyst, Danske Bank

Q

Hi. Good afternoon and thank you for taking my questions. I have two as well. So the first question is to Collecting Devices in Continence Care and the backlog that you're currently building up due to supply constraints. And is that a backlog that we should expect you to deliver on in the next fiscal year; so, say, incremental revenue on top of what would normally be expected for the Collecting Devices business? Or should we expect this backlog to sort of gradually fade out? And then second question is to China, and the development that you're seeing in patient volumes where are we? Have you begun to see any improvement in patient volumes since lockdowns were lifted? Or, yeah, what's the status? Thank you.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Thank you, Christian, two good questions. Collecting Devices backlog, great question. At this stage, we don't know. I would say back orders are poison to the business and back orders for this particular type of product, there are substitutes out there in the market. So we are going to lose some of these customers. They will not come back and buy our product again. So if you will, we don't just lose the revenue now, we also use the customer going forward. It's – which is, of course, unfortunate.

Some we will be able to convince to come back because they're used to using the product and then the final component of it is, of course, how long it's going to take us to get out of this of the supply issue. The net result of that, we don't know yet. But it's going to be, I know this is not helpful. It's going to be a bit between 0 and 100 somewhere. But you should certainly not expect the whole thing to come back. We don't.

And then patient volumes in China, we are still seeing a patient inflow at the 80 to 90 index levels. And I have to say, it varies once you take the lid of that number, you really see strong correlation between where we have lockdowns. So you may have region or a city where things look quite normal for a period of time. It gets locked down and then patient numbers decline. They decline immediately because hospital activity declines immediately. So it is a pretty dynamic situation. But in the aggregate for the total business, it's still sitting below where we'd like it to be. So it hasn't normalized yet. And with what we're seeing now, we certainly do not expect that we're going to see a normalization this fiscal year, probably not this calendar year either.

Christian Sørup Ryom
Analyst, Danske Bank

Q

Okay. Great. Thank you very much.

Operator: Thank you. Our next question comes from the line of Graham Doyle with UBS. Please go ahead. Your line is open.

Graham Doyle
Analyst, UBS AG (London Branch)

Q

Brilliant. Thanks for taking my questions. Two quick ones, and one slightly longer one. Just on Europe in Wounds, we know one of your peers mentioned, there might have been some stocking there, a similarly strong performance. Did you see any of that? And then you talked about US Ostomy and the progress there. Could you maybe give us a sense of the growth rate there to maybe compare to what you were doing sort of pre-COVID? So was it strong double digit or is a little bit below that?

And then one slightly more complex one, you're, obviously, targeting a 31% margin this year on an adjusted basis. And we discussed some of the headwinds in Hungary around labor and also energy. If we were to assume spot rates prevailed on energy for the next – the last three quarters, I suppose, of next year, and your wage pressure was to reach sort of low-double digits, so not as bad as last year, but sort of where the central bank are indicating in Hungary. Is it feasible to assume a 31% margin is deliverable? Are there levers elsewhere in the business that that mean you can generate that operating leverage? Thank you.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Thank you for those questions. Quickly on wound, at least from our view of our business, the number – the growth number that comes out of Wound Care from Europe is, if you will, a clean number, and reflects demand in the market for the products. We don't really see it in irregular purchasing patterns from customers. US Ostomy Care, I talked about it previously, this is clearly an acceleration in the business prior – also prior to where we were took to COVID. And it reflects, it reflects good wins, pull-through on wins. And of course it also reflects that we now go to market with a significantly larger sales team that we did pre-COVID. And so, we've got let me just phrase it like very solid double-digit growth.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

A

Yeah. And then, your third question related to how we are moving into next year as I understood, Graham. And so, it's something that we, of course, are currently working on. And our P&L for next year, everything starts with the top line. We are pleased to see the growth is coming back to pre-COVID levels. Kristian talked to China that is still some uncertainty, but more or less the other parts of the business are at the levels we have been focusing on in our Strive25 you can see strategy. And then, on top of that we have Atos. So, as we have said many times, we are expecting Atos to deliver growth in the level of 8% to 10%. And I would say so far so good, we have seen a strong momentum since we closed the deal earlier this year.

When we look at the gross margin development into next year, some of moving parts that I talked to earlier impacting our Q4 will continue into next year. And one of the bigger ones, that is the energy price levels, we see significant volatility on the energy price points, especially in Hungary and that's where there will be some additional headwind. But on the other hand, we also have a lot of focus on increasing prices across our business also into next year. As we mentioned earlier this year, we are expecting positive price impact this year and I'm actually also expecting that for next year also because we are not looking at any bigger healthcare reforms.

And then that brings me to the OpEx levels or the expense level. This year, our expenses are growing more than the slightly more than the revenue. Next year, we are going to be a bit more prudent on our costs. Also because of the uncertainties we see, especially around the gross margin and some of the dynamics I mentioned earlier. So those are some of the moving points, that we are working on and looking into for 2022-2023. I hope that gave a little bit more color to your question.

Graham Doyle
Analyst, UBS AG (London Branch)

Q

That's really clear. Thank you very much for that.

Operator: Thank you. Our next question comes from the line of Mattias Häggblom of Handelsbanken. Please go ahead, your line is open.

Mattias Häggblom
Analyst, Svenska Handelsbanken AB

Q

Thanks so much for taking my question. I have two, please. So Voice & Respiratory Care showed double digit underlying growth, which could mean quite a wide range of options, I guess, by definition. I think I understand what you're saying, but I was wondering if you could be a bit more specific what double digit means and talk about key drivers for this unit in the quarter. And then secondly, once the ramp-up is made and clear in Costa Rica, remind me how to think about your gross margin structure once utilization of this site gets off to an acceptable level. Thanks so much.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Thank you, Mattias. So I think I know I can say a bit more first. So, the underlying performance for Voice & Respiratory Care is very strong growth in laryngectomy, which is both teams and mid-single digit type growth in tracheostomy; but both in line with plan if anything is slightly ahead of plan. Good patient acquisition momentum. Good progress on improving retention. Good progress on working with product mix and the new products life plan. And we're also moving ahead, I think nicely with getting arms around the tracheostomy category. So the tracheostomy category is going to be a longer run. The company that Atos Medical had acquired before we acquired them called Tracoe will first have to be integrated into Atos and then we can integrate the whole asset. So but good progress from a growth point of view.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

A

Yeah. And Mattias, your second question around Costa Rica. So as you have seen in our material, we have just opened up our second factory in Costa Rica. So now we have our two factories and we are working hard on transferring machines from Hungary to Costa Rica. We expect that we, by the end of this strategy period, so in 2025, will have around 25% of total production volumes coming out of Costa Rica. I'm not expecting a significant impact on the gross margin due to this. Please remember, currently we're looking at a salary levels in Costa Rica that is of around index 80-ish versus Hungary. So we have some savings here. But on the other hand, we have increased costs related to transportation. But I'm not expecting a big impact on our gross margin due to these sites in 2025.

Mattias Häggblom
Analyst, Svenska Handelsbanken AB

Q

Perfect. Okay. Thanks so much.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

A

Thank you.

Operator: Thank you. Our next question comes from the line of Chris Gretler of Credit Suisse. Please go ahead. Your line is open.

Christoph Gretler
Analyst, Credit Suisse Securities Europe Ltd (Switzerland)

Q

Thank you, operator. Good afternoon, Kristian and Anders. I have actually two or three questions. First, on this Collection Device topic, could you actually quantify that?

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Yes, yes, we can. First off, was that – just give us all your questions and then we'll take them one by one.

Christoph Gretler
Analyst, Credit Suisse Securities Europe Ltd (Switzerland)

Q

Okay. And then the second question is with respect to raw material costs and freight costs, could actually you discuss, how that looks on a sequential basis? I mean, I understand year-over-year, there is significant increase. But if you look at, kind of, on a sequential month-over-month basis, are these cost items still going up? Or do we – have we flattened so to say? I'm just asking, for example, in line, if I look at the oil price now has come down quite a bit already and I guess some of your input costs are in our oil price derivatives in the end. And then the third question is on the availability of stack. I remember some in the past, there was some challenges there. How do you see the situation right now? Are you happy about it on the supply of [indiscernible] (00:46:55)

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Thanks. The last question pertained to a particular geography or is this a global question, Christoph?

Christoph Gretler
Analyst, Credit Suisse Securities Europe Ltd (Switzerland)

Q

I mean, I think it was mainly on the Hungary back in the days. But I guess, I mean, getting so many qualified people in Costa Rica might also be a challenge given, some more people were looking for this type of stuff.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Yeah. Okay. Let me – I'll take a stab at question one and three and then Anders can take a stab at question two related to raw materials. So if you look at the Collecting Devices issue and if you will the scale of the impact, you should think of it as around the 1 percentage points worth of headwind this quarter. And we believe that this is going to persist all the way through Q4. And this is of course for Continence Care, so 1 percentage point of headwind for Continence Care. So you could add that back to the Continence Care number. But to Christian's earlier question, how much of that business is lost? We don't know, right? So – but the net effect clearly is negative.

And to your latter question on availability of staff, Hungary is still a red hot labor market. The labor market is short, particularly for blue collar, but also building a good cadre of specialist staff. So we are definitely seeing that it's still challenging. Our turnover rates are okay, our people turnover rates are okay. So we are – we're managing through it, but we've got a lot of people who are working on this. And as you'll recall earlier, we were basically under so much pressure that we recruited people into Hungary from Ukraine and we also have contingency plans, Christoph, that we can go to other geographies than Ukraine for labor if need be. We actually have a pretty good process for doing it, but still challenging; for Costa Rica, a lot less, a lot less.

Okay. Anders?

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

A

Yeah. Christoph, related to your second question around the raw materials. So we are starting to see that the increases are starting to you can say be at a lower level, you can say so it has – it's about to top, but it is still going to impact our business versus last year into our Q4. And the same thing goes for freight costs or the freight prices. It also seems it's starting to flatten out. But on energy, here we continue to see increases, especially in Hungary. So on the energy prices here we continue to see increases currently.

Christoph Gretler
Analyst, Credit Suisse Securities Europe Ltd (Switzerland)

Q

Okay. Thank you. Appreciate it. And hope to see you in two weeks times.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

Likewise.

Operator: Thank you. Our next question comes from the line of David Adlington of JPMorgan. Please go ahead. Your line is open.

David Adlington
Analyst, JPMorgan Securities Plc

Q

Hey, guys. Thanks for questions. Two please. Firstly on OpEx, delving in a bit more. There's a big increase in distribution costs in the quarter, both of the year-on-year, but also sequentially quarter-on-quarter. Just wondering if you can give a bit more color on that because that was a DKK 200 million-ish increase in sort of trying to pass out what was the driver of that and how we should be thinking about that into the fourth quarter. And then secondly, just question on the Wound Care market, the Wound Care market seems to be in pretty good health. I wondered what you thought were the key drivers behind that. Thank you.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

A

Yeah. Hi, David. It's Anders. Let me take your first question. So in terms of our distribution cost, please remember that that's where we have the amortization costs related to Atos. And so, that's part of that cost. And on top of that, we also have logistics in that cost category. And here we are seeing as a consequence of the price increases, increased cost levels also significantly higher cost increases than our top line growth. And then, in the quarter, we also, as the restrictions are becoming more and more and more behind us, we have had more travelling and we also had more seats in marketing events than we had the last year because of the restrictions. So, those are some of the main reasons, but please remember the amortization that is part of our distribution cost in our P&L.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

And then,

[indiscernible] (00:51:57)

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

No, go ahead.

David Adlington
Analyst, JPMorgan Securities Plc

Q

Thanks. Thanks for the question. Just into the follow-up, I mean the amortization was presumably in there in the second quarter as well though. So we still got a DKK 200 million in Q3 and Q2.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S
A

And please remember, Q2 only included two months and now it's including three months of amortization. So that's one of the reasons.

David Adlington
Analyst, JPMorgan Securities Plc
Q

Right. Thanks.

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S
A

Kristian?

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S
A

On Wound Care, remember the particular geographical profile that our Wound Care business has, which we believe explains the discrepancy to others. So, we have very healthy growth in Europe. We're doing well in Europe. But we have a one of our largest Wound Care businesses in China and we have negative growth in China. And then, finally, I'll also just remind you that our presence in the US, we're really not exposed to, I think, the rebound that's been happening on the US simply because we have very little business in Wound Care in the US because we don't have our portfolio in place yet. So net-net US and China – we're not getting any benefit from a US rebound with negative growth in China, but Europe's doing well. EM is also, by and large, doing well.

David Adlington
Analyst, JPMorgan Securities Plc
Q

It's a great color. Thanks very much.

Operator: Thank you. Our next question comes from the line of Grace Lee at Jefferies. Please go ahead. Your line is open.

Grace Lee
Analyst, Jefferies International Ltd.
Q

Thank you for taking my question. Two questions, please. Well, first on China, I think just clarify, Ostomy Care in Q2 was flat growth versus negative in Q2. But then you mentioned new patient inflow index remaining at 18%, 19% level, I think, which is same as Q2. So how should we square that, if you can help us with that? And how – you have mentioned also about [ph] EBT (00:54:04) little bit remaining low level. Again, if you could quantify that will be really helpful. And then second question is around 4Q organic growth. How are you sort of thinking about that or how we should think about that in terms of given that Continence headwinds persist as well as tender [indiscernible] (00:54:21) as well. Thank you.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S
A

Could you just repeat the question on Q4.

Grace Lee
Analyst, Jefferies International Ltd.
Q

How we should think about the organic growth given the Continence headwind and OC tender phasing headwind in OC. Thanks.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S
A

Yeah. So just to recap for what we're saying about Q3 for China. For – so full year, we expect for OC China is low single digit. We're going to have a negative growth year for Wound Care, but low single digit for OC, part of the effect, even though you have a lower inflow of patients, is we continue to work on product mix, we continue to work on initiatives in our direct channels both the digital channel and our mail order channel. We actually have growth in both. The story on China is really a hospital story. And it's these, if you will, patchy lockdowns that happened and the government plays COVID whack-a-mole, it opens up again, activity levels pick up again, it closes down again, the activity levels fall; and so it's dynamic.

Zooming out, I net all those numbers up, we are to my answer earlier, we don't have the same inflow of patients coming into the business as would be normal. But we're going to have low single digit growth on Ostomy in China this year. This is way, way below what we normally do, but way below. So, China has been a growth engine for the company for a long time. We've invested for a long time. And so, I mean we can't wait for China to get through COVID and start to contribute again and that we get full access to hospitals like we used to do.

And then for Q4 really, I mean, the big swing factor compared to last year is that you need you should remember that last year we had a very, very strong quarter in Q4 in emerging markets, which is mathematically a headwind. And then of course, we've got Collecting Devices that I commented on earlier which is about a percentage point of headwind to the Continence Care business, everything else being roughly equal.

Grace Lee
Analyst, Jefferies International Ltd.
Q

Okay. Thank you.

Operator: Okay. And we have one further person in queue. That's Oliver Metzger at ODDO BHF. Please go ahead. Your line is open.

Oliver Metzger
Analyst, ODDO BHF AG
Q

Hi. Good afternoon. Thanks for taking my questions. The first one as a follow-up on your ASP question. So could you be a little bit more specific regarding the contribution of price increases to organic growth? Is it just, let's say, below 1%? So any indication would be great. Second is on your factory in Costa Rica and also the overall cost inflation. So not cost level but cost inflation. Could you give us an indication of how cost inflation develops in Costa Rica?

And my last question is on penile implants. In the past, there was also this relation between weak economy and the number of penile implants surgeries. There are quite different dynamics nowadays. Intuitively, high inflation might have some negative impact, but on the other hand, we see also a labor market which is more or less healthier than ever and as basically for patients, as the procedure is completely reimbursed, but the patients' fear of losing their job if they go for surgery. Do you think that even this better prospect on the labor market might lead to more surgeries than one might think intuitively?

Anders Lonning-Skovgaard
Chief Financial Officer & Executive Vice President, Coloplast A/S

A

All right, Oliver. Thanks a lot for those questions. Let me start with the first two ones. So your first question related to price increases. As we have mentioned throughout this year, we have worked a lot on this lever and we have currently, I think also I called it out at the previous quarter something around 80 activities going on in order to increase prices across the group.

We are getting some price increases, for instance, in the UK. Here, we have some adjustments to the underlying reimbursement levels. You're also getting some increases in the US and in a couple of other markets. And then, we are also looking into emerging markets, working with price increases, working with distributor margins, et cetera. So, when we add all of that up, we are expecting a net positive impact of this year and we have already initiated a number of things also moving into next year. And with the knowledge we have currently, we are also expecting a net positive impact into next financial year, under the assumption that we are not seeing any healthcare reforms.

In terms of your second question, as I remember, your question was around inflation in Costa Rica and therefore, my memory, we are sitting with an inflation of low single digits in Costa Rica.

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

And then, Oliver, to the speculations about your macroeconomic conditions and people's appetite to get a penile implant, I don't think that there is necessarily a clear correlation. I think much of what you've seen has happened is down to the team that we have running this business, how they run the business, the offering that they have, the way they work; and I'd say, a lot of the things that they've learned working through COVID on how you market to both physicians. But in particular, to patients and guide them through, if you will, the decision funnel from considering to have the intervention to actually booking an appointment to not cancelling the appointment, actually showing up to get the procedure done; it's down to, all of those operational tactics. So we have a business that's growing nicely. But I will refrain from speculating too much about how it relates to the macroeconomic development. I'm not sure how it would.

Oliver Metzger
Analyst, ODDO BHF AG

Q

Yeah, but would you say that it is now potentially more resilient due to your initiatives than was some years ago?

Kristian Villumsen
President & Chief Executive Officer, Coloplast A/S

A

I think it is fundamentally resilient, which has also been borne out in the performance that we've seen. That said, we still have to innovate. We still have – we're still doing things in the pipeline for the business. It's a competitive segment. We have a strong competitor. So, we have to keep on our toes. We have a team that's very, very customer-oriented. And that's what I think drives the share gain along with a strong product offering. But we have to keep innovating and stay on our toes. I look at it as a good, resilient segment that we're in.

Kristian Villumsen

President & Chief Executive Officer, Coloplast A/S

I think with that, this call is about to close. And I hope that we have a chance to see many of you in person at our upcoming Meet the Management at the end of the month here in August, at our headquarters in Denmark. Have a nice day, everybody.