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DRWG.DE - Q3 2021 Draegerwerk AG & Co KGaA Earnings Call

EVENT DATE/TIME: OCTOBER 28, 2021 / 1:00PM GMT

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PRESENTATION

Operator

Good day, and welcome to the Drägerwerk Q3 2021 Earnings Call. Today's conference is being recorded.

At this time, I would like to turn the conference over to Stefan Drager. Please go ahead.

Stefan A. Drager - *Drägerwerk AG & Co. KGaA - Chairman of the Executive Board - Drägerwerk Verwaltungs AG*

Good afternoon, and a warm welcome to everyone joining us today for our 9-month financial results. Today, I have with me Gert-Hartwig Lescow, CFO; Tom Fischler, Investor Relations; and Peter Müller, Financial Communication.

We would like to take you through the presentation on the results that we have made available on our website this morning and we -- which we had to pre-release some 2 weeks ago.

I will kick off with an overview of some business highlights of the last quarter before I get happy to go into the financial details. I will then close the presentation with the summary and our confirmed outlook. After the presentation, you will have the opportunity to ask your questions. Out of respect for everybody's time, we will end this conference in 1 hour.

Starting on Page 3, we will now look at the business highlights. The special demand situation for Dräger caused by the pandemic persisted longer than originally anticipated. Order intake for Dräger products needed to treat patients suffering from COVID-19 remained at a high level during the first half of the year. As a result, and as you all know, we have increased our guidance for the full year 2021.

Towards the end of the second quarter, we have seen pandemic-driven demands to come down. While some normalization of demand has continued also during the third quarter, that normalization is proceeding slowly. Hence, pandemic-driven demand still supported our order entry also in the third quarter. Especially for ventilators, we are still receiving some larger orders here and there with little lead time.

In addition to that, industrial demand in safety has picked up again in some areas. Demand for gas detection, for example, was strong. As a result, order entry in the third quarter developed well. Therefore, today, we confirm our updated guidance from June.

In line with the expectation of the softer pandemic-driven demand in the months to come, we have reduced our production output for relevant products, especially intensive care ventilators. As a reminder, we produce our ventilators at our existing facility here in Lübeck. Lead times for customers are better or normal again. And we are able to supply to customers quickly as needed.

Our FFP mask production is still running at a high-capacity utilization as the large government mask orders we received last year partially will be produced and delivered. For [mortality], we see an oversupply on the mask markets. This could make it difficult to win sufficient new mask orders necessary to maintain the high utilization of our protection after the existing orders have been completed.

But we are confident to see an improving mask demand in the coming months and year. This should help us to implement our mask growth strategy. In case the recovery of the demand size does not materialize over the next couple of months, we will, of course, adjust our capacity accordingly.

There has been lots of news on the very difficult supply chain situation for many industries due to the shortage of electronic components like microchips. So far, we at Dräger have had no meaningful disruption caused by such shortage of parts.

However, the situation has started to become more challenging. Some components especially for some safety products in the meantime are very difficult to get. The situation is clearly not at all as dramatic as it is for the car manufacturers. But nevertheless, this causes a risk for our supply chain again.

In addition, we are facing high cost for transportation and logistics as well as a tendency of suppliers to increase prices. We will continue to mitigate this cost inflation by passing on higher prices to our customers. This risk is the main reason why we remain cautious and do not expect too much upside from Q4 this year despite good order entry in Q3.

What is new on the development side? We continue to implement our hospital strategy. We have entered into an exclusive agreement with Sony to expand our real-time location service, RTLS, product portfolio for hospitals. Dräger is taking over the design, development and marketing of the RTLS location solution from Sony Network Communications Europe.

We will continue to market the real-time location system under our own brand. The RTLS product, which we will market under the name Dräger Discover basically as a work-based software solution, with which you are now able to view and localize all your connected hardware throughout the hospital. It consists of a centerpiece of hardware you attach to your existing hospital equipment like a transport ventilator, for example.

This will enable us to provide value to our customers and help possible to further improve acute care [retro] through continuously available location information and real-time services. Furthermore, our work on the implementation of measures to remedy the deficiencies identified by the FDA remain a strong focus, and our activities remain on track.

Now let's turn to the business development of the group. For that, I would like to hand over to Gert-Hartwig. Please.

Gert-Hartwig Lescow - *Drägerwerk AG & Co. KGaA - CFO, Executive Board Member for IT & Vice Chairman of Executive Board - Drägerwerk Verwaltungs AG*

Thank you, Stefan. I would also like to welcome you all to our conference call on the results for the first 9 months. But before starting with the financial development of the group, I would like to clarify that whenever I will put the growth rate, I will give the values in constant currencies unless otherwise stated.

Let us now start with the business development of the Dräger Group on Page 4. Order entry in the third quarter was surprisingly strong. We had expected a more meaningful normalization of the pandemic-related demand. But while there is an underlying trend of softer demand for products needed to treat COVID-19 patients, the normalization in Q3 was slower than expected.

Order entry for ventilators is still well above pre-corona levels. In addition, some recovery of industrial demand has led to order entry in Q3 being above previous quarters. The almost EUR 760 million order entry in Q3 was above the level of the first and second quarter of the year. Compared to 2019, the year not yet affected by the pandemic, order entry in the third quarter of this year is roughly 10% higher.

Net sales in the third quarter amounted to just below EUR 770 million. This was substantially below the highest sales level of the last quarters impacted by COVID-19. However, net sales are still above the levels we last saw before the pandemic. Thus, sales are still more than 16% above the third quarter of 2019.

Lower volume during the quarter and the lower gross profit margin of 46.9% resulted in a decline in [endorsement]. The development in this segment was in the opposite direction, where both net sales and gross margin declined significantly in the (inaudible). The safety division recorded a noticeable increase.

In the current year, essential costs have increased compared to the subdued level of 2020. During extended periods of the pandemic, hiring of new personnel, travel and marketing activities were cut. Many of these necessary activities have recommenced during the last couple of months, increasing the expense base.

As a result of the aforementioned, lower net sales volume, lower gross profit margin and higher expenses EBIT is substantially below the level of the previous year at just below EUR 48 million for the third quarter. Looking at the 9-month period, this ends up to a year-over-year net sales development of plus 6.3%.

Deliveries increased in all regions, with the strongest growth in the Americas and Africa, Asia and Australia. In the first 9 months of 2021, our gross profit increased by more than EUR 75 million. This development is attributable to the pandemic-driven sales growth over the first half of the year as well as the positive [countries mix].

While the gross profit margin is still up year-on-year by about 1 percentage point, that is mainly due to the low Q1 margin included in the 2020 base numbers, which at the early stage of pandemic, was not yet, by any way, meaningful pandemic mix effect, which at times have supported the group's gross profit margin by up to 4 to 5 percentage points. With fading pandemic tailwind, we're currently seeing a lower gross profit margin over the last couple of months, a margin trend that will continue with changing mix effects. For the full year, the gross profit margin should come out roughly on the level of the prior year.

With personnel expenses up to some 6.5% mainly due to higher personnel expenses, EBIT amounts to EUR 257 million. In the 9 months' period overall, currencies did not have a meaningful impact on the EBIT margin. And should exchange rates remain on current levels, they wouldn't burden profitability for the full year, either. Our Dräger Value Added increased by more than EUR 127 million to a total of EUR 320 million.

Moving on to the medical division on Page 5. Due to order adjustments in the third and fourth quarter of 2020, we started to take the partially canceled large order of the German government out of the order book. The comparison with the previous year is only meaningful to a limited extent. But as mentioned before, order entry in medical in the third quarter was surprisingly strong. Especially order entry for ventilators is still above the pre-corona level.

We have received some large orders from some countries where the pandemic is still quite challenging, like Vietnam or India. As a result, the demand for products needed to treat COVID-19 patients is only slowly normalizing. In addition, service -- some regulation and workplace infrastructure product areas that have been burdened during lockdown situations last year are recovering and seeing higher order entry levels again.

Despite the favorable order entry levels, net sales was below the prior quarter and amounted to EUR 470 million, which is some 23% below the strong prior year quarter, decline in all regions. Due to lower net sales volume in the quarter as well as an unfavorable product mix, the gross profit margin decreased by roughly 2.5 percentage points compared to the margin 1 year ago. Q3 EBIT was just below EUR 26 million, corresponding to an EBIT margin of 5.5%.

For the 9-month period, order entry of EUR 1.4 billion was well below the record level of 1 year ago. But our net sales in the medical division were virtually unchanged in the first 9 months at EUR 1.5 billion. This development was mainly attributable to a decline in the Europe region with -- while shipments increased in the Americas region as well as in Africa, Asia and Australia.

Gross profit margin as well was on the level of the previous year due to some positive mix effects. The gross profit margin even slightly increased by 90 basis points. The very good gross profit from the first quarter compensated for the decline in the second and third quarter.

The EBIT of the reporting period amounted to some EUR 171 million, which is below the record last year. Also, the strong prior year EBIT in Q4 will not be met this year so that the full year EBIT will remain substantially below the 2020 credit. As we said before, net sales and earnings have substantially benefited pandemic-related tailwind in 2021. We continue to expect a further normalization of this effect, which will result in a lower business development in the following year. And finally, strong improvement of the DVA of the medical division, which is up from EUR 67 million to EUR 246.6 million.

Let's now to look at the development of the safety division on Page 6, starting with the development in the third quarter. The safety order entry is currently no longer benefiting from pandemic-related demand. As a result, compared to the record level 1 year ago, the safety division's order entry declined by more than 20% in the third quarter.

In the prior year period, we have received a major order from the United Kingdom for FFP masks. Adjusted for this major order, order entry would have increased in the third quarter by roughly 12%. We are seeing some recovery of the industrial demand, which had declined during the first quarter of the pandemic. Due to some catch-up investments, order entry currently is above the pre-corona levels.

Net sales in the third quarter increased by roughly 14%. This strong growth rate is due to the fact that we are currently delivering the largest FFP mask orders received last year. In the comparable figure of Q3 2020, we just started deliveries, and the production output of the new facilities was not fully intimated yet. All regions contributed to this growth with similar growth rates in the teens.

In line with the increased sales volume, gross profit improved significantly in Q3. And due to some favorable mix effects, the gross profit margin increased by some 1.5%. Q3 EBIT nearly doubled to a total amount of EUR 22.1 million, lifting the EBIT margin to 7.4%.

Looking at the 9-month period, net sales increased by 19%. The gross profit margin increased by more than 1 percentage point, again, driven by favorable product and country mix effects. Mainly due to higher personnel expenses, essential costs for the safety division were up 8.1% year-on-year, EBIT of the first 9 months of the year as well over the level 1 year ago. EBIT nearly reached EUR 86 million from EUR 50 million, above the EBIT level 1 year ago. Due to the higher earnings, DVA improved and increased to EUR 78.4 million.

Turning now to some other key figures of the Dräger Group on Page 7. With more than EUR 266 million, cash flow from operating activities remains strong and is considerably higher than in the previous year. One factor behind this improvement is the higher EBIT in 2021. In addition, the strong collection of trade receivables and a lower buildup of inventories also contributed significantly to the positive cash flow development.

Strong development of our operating cash flow was achieved despite its decrease in trade accounts for their payable and other [prepaid] expenses. Last year, we acquired the purchase options for respiratory equipment. This purchase option is higher than the third quarter and is now fully [running]. From the fourth quarter onwards, there is no further impact on sales, earnings and cash flow.

Moving on to free cash flow. The cash outflow from investing activities is substantially below the prior year's cash outflow. Here, one needs to take into account that the investing cash flow includes net cash inflows in the amount of EUR 60 million from divestment of money market funds, which we had acquired to avoid negative interest on -- especially for the deals due.

Cash outflows from investing activities include the acquisition of STIMIT and UAX as well as investment into our production facilities. In consequence, our free cash flow is substantially above the prior year's level at roughly EUR 244 million.

Net financial debt is on a level again after the sharp increase last year due to the cancellation of participation certificates. Also, the equity ratio has increased to just below 40%. The improvement in the equity by almost EUR 221 million is mainly attributed to the significant increase in earnings. In addition, the early partially -- partial repurchase of participation certificates in the amount of EUR 100 million contributed to the quick recovery of the equity ratio.

That is it from my side. I'd like to turn it over back to Stefan.

Stefan A. Drager - *Drägerwerk AG & Co. KGaA - Chairman of the Executive Board - Drägerwerk Verwaltungs AG*

Thank you, Gert-Hartwig. Let me close with the outlook for the current fiscal year. Following the strong demand development, which was above our previous expectations, we raised our full year guidance at the end of June. Compared to the record level last year, we anticipate a decline only between 2% and 6% in currency adjusted net sales. While at the beginning of the year, we had expected net sales to decline by as much as 11%.

In line with the higher expected volume, the associated tail effects and the expected product mix, the expected earnings have also increased. The EBIT margin is expected to reach between 8% and 11%. The set of figures presented today basically confirms this expectation.

While the good order entry of Q3 seems to make the upper end of the top line more likely, the risks of the supply chain from material shortages make it unwise to take the higher end of the guidance range for granted. Today, we therefore confirm the full range of our published guidance for 2021.

How do we think about 2022? 2020 and '21 are not normal years, nor will '22 be. After the record year 2020, it was obvious that we will see a lower top line in 2021. As the normalization of the demand has kicked in much later and is slower than anticipated, '21 will also be a strong year for Dräger, stronger than originally expected and definitely a very challenging comparable basis for '22.

We do not expect comparable demands to repeat next year. Demand for ventilators, patient monitoring and FFP masks will be below the pandemic-driven years '20 and '21. In addition, material shortages and increasing [buy] Chinese tendencies are uncertainties that will remain with us also in '22.

On the other side, the non-pandemic demand has still to improve. So far, we have seen some areas with growth recovery. But there are other areas that still need to improve compared to the subdued levels during the pandemic present.

Profitability-wise, we will see sustaining positive mixes. All in all, [2022] (corrected by company after the call) will be a transition year. Based on our investments into our own and into specific sales capabilities, we expect to see a return to growth and higher profitability again thereafter. We will provide details of our guidance of 2022 when we publish the results for the fiscal year 2021 early next year.

With that, I would like to end the presentation and hand over to the operator to open the line for your questions. Please.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Oliver Reinberg with Kepler.

Oliver Reinberg - *Kepler Cheuvreux, Research Division - Head of Med Tech Equipment & Services Research*

Three, if I may. Firstly, specifically on the demand trends for ventilators. Can you just provide any kind of color for next year? Is it more likely that you're going to see a normal year in terms of a normal year compared to before the pandemic? Or would you expect that we're actually tracking below a normal level given the kind of placements in the market that we've seen over the last 2 years?

Secondly, on the warning letter. Can you just provide an update in terms of timing, in particular when it comes to the filing strategy for key new products in the area of monitoring and anesthesia?

And the third question, thanks for the color that you provided for next year already. Can you just add a bit more in terms of what is the flexibility in your cost base? So what are the key moving items? To what extent would you expect the kind of headwind from normalization of marketing and traveling costs? And to what extent can you actually scale down certain cost items that may be related to temp worker on the back of this kind of pandemic demand?

Stefan A. Drager - *Drägerwerk AG & Co. KGaA - Chairman of the Executive Board - Drägerwerk Verwaltungs AG*

Yes. This is Stefan speaking. Thank you, Oliver, for your question. The demand for ventilators, I would expect for the '22 to be better or normal but not below normal. There may be a few places or countries that have really some kind of saturation effects, but some others are still catching up. So in total, I would expect normal. So back to the plan we have made for '22 in '19 levels.

Your second question on the FDA, the remediation, that is on track. And so we expect the certification in due course sometime in '22 and all restrictions to -- being lifted and back to normal from that respect.

On the cost base for '22, I hand over to Gert-Hartwig.

Gert-Hartwig Lescow - *Drägerwerk AG & Co. KGaA - CFO, Executive Board Member for IT & Vice Chairman of Executive Board - Drägerwerk Verwaltungs AG*

The cost base, I think they were -- we are -- the question was a color on the cost base for '22. So there are a few elements where we actually do see some risk for the cost base. And that includes the buildup on the research and development side, following our growth plan as well as, for example, some of the travel cost, which obviously have gone down in 2020, 2021, with fewer activities due to corona. We have -- and we are reckoning with some higher cost inflation on the material cost base, which we do plan to pass on to the customer, to the degree where we see them.

We have adjusted our production already in the ventilation side. So we have scaled that down. And so there will be no remaining cost, if you will, from the ramp-up of our ventilator production. That's all absorbed in 2021. And looking forward, the further flexibility and -- is, of course, in the dynamics and -- with which we build our production and which we will build production now.

Stefan A. Drager - *Drägerwerk AG & Co. KGaA - Chairman of the Executive Board - Drägerwerk Verwaltungs AG*

And your point on the expectations on the wage increase, we do have in place still as well for all of the year '22 and I guess (inaudible) is the trading in IG Metall. They have no wage increase. However, we are currently in negotiation to trade that in for something more useful for all parties before the midterm future. So the worst case for us is go back to this 0 increase for '22.

Oliver Reinberg - *Kepler Cheuvreux, Research Division - Head of Med Tech Equipment & Services Research*

May I just follow up? Can you comment in terms of when you expect the filing for key new products in the U.S. on anesthesia monitoring?

Stefan A. Drager - *Drägerwerk AG & Co. KGaA - Chairman of the Executive Board - Drägerwerk Verwaltungs AG*

During the course of next year, I would think when -- it's all in line with the deviations of the issues raised and the one that we received 1.5 years ago.

Oliver Reinberg - *Kepler Cheuvreux, Research Division - Head of Med Tech Equipment & Services Research*

Okay. Super. And last question on the kind of Sony collaboration that you talked about. Is that an add-on? Or is that something that we should bear in mind also for modeling purposes?

Stefan A. Drager - *Drägerwerk AG & Co. KGaA - Chairman of the Executive Board - Drägerwerk Verwaltungs AG*

It's included in the guidance. And it is interesting from a strategic perspective because it is paying in the digitalization. And it's a pure digital business model, as you will, without classical hardware, with great customer intimacy and knowledge where we already benefited last year. We're in a pilot. I think we may have already mentioned that allowed the Robert Koch Institute in Berlin to have a near-term view of the application and, let's say, utilization of ICU bed of the connected hospital.

Operator

(Operator Instructions) I am showing no further questions at this time. I will now turn the call back over for closing remarks.

Stefan A. Drager - *Drägerwerk AG & Co. KGaA - Chairman of the Executive Board - Drägerwerk Verwaltungs AG*

Well, thank you very much, all of you, for being with us today online and your continued interest in Dräger. And we look very much to see you sometime in the near future, again, in person. Until that, hold on and stay healthy and have a pleasant rest of the day. Thank you very much for being with us and bye-bye.

Operator

Thank you. Ladies and gentlemen, this concludes today's teleconference. You may now disconnect.