

UFPT Earnings Call Transcript

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Quarter: 3

Operator: Good day, and welcome to the UFP Technologies Third Quarter 2025 Earnings Conference Call. [Operator Instructions] Please note this event is being recorded. I would now like to turn the conference over to Ronald J. Lataille, Senior Vice President, Treasurer and Chief Financial Officer. Please go ahead.

Ronald Lataille: Thank you, operator. Good morning, and thank you for joining us on our third quarter 2025 earnings conference call. With me on today's call is our CEO and Chairman, Jeff Bailly. Today, we will make some forward-looking statements within the meaning of the U.S. Private Securities Litigation Reform Act of 1995, the accuracy of which is subject to risks and uncertainties. Wherever possible, we will try to identify those forward-looking statements by using words such as believe, expect, anticipate, pursue, forecast and similar expressions. Our forward-looking statements are based on our estimates and assumptions as of today and should not be relied upon as representing our estimates or views on any subsequent date. Please refer to the cautionary statement regarding forward-looking information and the risk factors in our most recent 10-K and subsequent 10-Qs, including disclosure of the factors that could cause results to differ materially from those expressed or implied. During this call, we will discuss non-GAAP financial measures, which include organic sales growth, adjusted gross margin, adjusted operating income, adjusted SG&A, adjusted EPS and EBITDA and adjusted EBITDA. A reconciliation of GAAP to non-GAAP measures discussed in this call is contained in the associated press release and is available in the Investor Relations section of our website. I'll now turn the call over to Jeff.

R. Bailly: Thank you, Ron, and thank you to everyone joining the call. UFP delivered solid Q3 results despite absorbing abnormally high costs related to the labor inefficiency challenge at our AJR Illinois facility. Overall sales grew 6.5% to \$154.6 million. Our MedTech business grew 7.3% with impressive growth in Interventional and Surgical, Orthopedics and Wound Care, each of which grew greater than 30%, offset by a 23% decline in Patient Services and Support, which is our AJR, Stryker business. Advanced Components or non-medical business declined 2.7% as we continue to focus the majority of our resources on our MedTech business. AJR, of 6 acquisitions we completed over the last 15 months, faced an issue when we went through the process of verifying the team's eligibility to legally work in the U.S. The e-verify process led to the turnover of greater than 50% of the direct labor workforce. Retraining a large percentage of our workforce reduced our output, resulting in a significant reduction in revenue and a third quarter \$3 million reduction in gross profit and operating income and a \$0.28 reduction in diluted EPS. We expect much of the revenue from delayed orders will be recaptured in the coming months when our capacity ramps back up to required levels, and we can work down the backlog of open orders. We've made significant progress in hiring and training new associates. July was the low point of our inefficiency when we suffered a significant loss in Illinois. And have made steady progress since with a smaller loss in August and a return to solid profitability in September. Although we expect the inefficiency to impact a couple more quarters, the greatest impact is now behind us. AJR's results in the Dominican Republic should also continue to improve as qualifications are completed and production of transfer programs ramps up. Our first program is in commercial production. The second is in the qualification process, and we anticipate a third program transferring in 2026, all of which was contemplated in our 5-year exclusive supply agreement with Stryker. On the

robotic surgery front, revenue was up 5.1% in Q3. We are completing the launch of 2 significant new programs. The combined revenue of those 2 programs should be greater than \$10 million in 2026 and then continue to grow rapidly from there. We are also in discussions to increase and extend our \$500 million contract with our largest customer. They've asked us to plan for significantly increasing volumes. Both companies plan to make multimillion dollar investments towards increasing capacity and efficiency at our La Romana facilities. We are simultaneously working on extending our exclusive supply agreement for a critical raw material in robotic drapes. As a result, we remain very bullish about our long-term future robotic surgery. Our 2 recently completed acquisitions, UNIPEC and TPI are both performing well ahead of expectations and have been immediately accretive to our earnings. Organic growth for UFP was essentially flat in Q3 due to the reduction in AJR sales quarter-over-quarter. Setting aside acquisitions completed in the prior 15 months, UFP's base business grew approximately 5%. In conclusion, we have a lot of positive momentum and good news to look forward to. AJR's return to profitability and improving operating efficiency as new team members complete their training, positive impact of the transfer business in the Dominican Republic launching and then reaching commercial production, 2 new robotic surgery programs launching and beginning commercial production, an extension in process for our long-term contract with our largest customer with significantly increased volumes contemplated and planned multimillion dollar capital investment by our customer and the positive impact of our recent acquisitions, combined with our efforts to find strategic acquisitions that increase our value to customers. I will now hand it over to Ron to provide additional details on our financial results.

Ronald Lataille: Thank you, Jeff. I am also pleased with our third quarter results as we delivered solid numbers despite working through the large nonrecurring labor challenge at AJR. Before I provide more color on these numbers, I'd like to start by providing a brief update on tariffs. As mentioned in our second quarter call, we do not expect to be directly subject to a material amount of tariffs, and that was true in our third quarter when we paid approximately \$160,000 in tariffs to the government, of which all was or will be passed through to our customers. On the supply side, our new estimate of the annual amount of tariffs to be passed through by our suppliers is approximately \$6 million, down from the \$9 million estimate in Q2. Like the direct tariffs, we anticipate passing through the raw material increases to our customers, some of which have already occurred. Switching back to operating results. As Jeff mentioned, organic sales were essentially flat as the AJR business flipped from inorganic to organic for all of Q3. Due to the labor problem at AJR, more than \$8 million in incremental orders were unable to be fulfilled during the quarter. Had we been able to meet the production demand, organic sales would have grown approximately 6%. In light of these unfilled orders, backlog going into Q4 is approximately \$16 million, much of which we expect to fulfill by early 2026. Gross profit as a percentage of sales or gross margin decreased to 27.7%, largely due to the \$3 million in extra labor costs incurred at AJR, which are all reflected in cost of sales. Absent the \$3 million in additional labor costs, gross margins would have increased to 29.6%. As Jeff mentioned, we have turned the corner in terms of recovery. And in fact, last week, the amount shipped were 3x higher than the low point since the problem surfaced. Adjusted operating margin for the third quarter was 17% of sales, within our target range despite the \$3 million of extra labor costs. Interest expense was down significantly as we continue to delever our balance sheet and our effective tax rate of 22.2% for the third quarter was down slightly from a year ago. During the third quarter, we generated \$35.9 million in cash from operations, paid down approximately \$17.5 million in debt and ended the quarter with a leverage ratio well below 1.5x. Capital expenditures were \$3.4 million. With that, I now turn it back to the operator for questions.

Operator: [Operator Instructions] The first question comes from Justin Ages with CJS Securities.

Justin Ages: Can you give us a bit more color on the growth in robotic surgery, that 5%? How much was from your largest customer? Any more details on that?

R. Bailly: Yes. So if you do the math on our largest customer, their growth was actually higher than that. It was closer to 8%. And the reason is we had this sort of 1-year phenomenon where if you go back in time, we were producing pouches, the sort of critical part between the robot and the surgical instrument for the last couple of decades, some of which were sold directly to Intuitive Surgical, some of which were sold to our competitor. When we moved to Dominican Republic, those sales were no longer to an outsider. They were part of the product that we sold to Intuitive ourselves. So there's -- this is 1 year

where this impact is going to happen. So robotic surgery sales of about 5.1% was a blend of Intuitive Surgical being higher than that, offset by this onetime impact.

Justin Ages: That's helpful. And then on the -- some of the other MedTech, the Interventional Orthopedic that grew, I think you said strong around 30%. Just looking any indication or any hints of the demand that you're seeing, if we can expect that to continue going forward?

R. Bailly: Yes. I mean we were seeing very strong demand in all 3 of those markets. It was a blend of some of our acquisitions and some of our internal growth. But the only market really across the board that we saw any compression in related to patient services and support, which is literally our AJR/Stryker. So we see like a nice tailwind in most of our markets, offset by this sort of onetime item that we have to work our way through.

Operator: The next question comes from Brett Fishbin with KeyBanc.

Brett Fishbin: I wanted to follow up on some of the commentary about the contract dialogue. I think you noted in the press release and then again in the prepared remarks that you're in discussions to extend and expand that contract with your largest customer and mentioned that volumes are expected to increase significantly. So I wanted to follow up and just see if there's any additional color you're able to provide on that. And I was really wondering, does the word expand imply that the contract may include additional SKUs relative to what's been done in the past? And then can we assume that higher volume also means higher overall value for UFP.

R. Bailly: So yes, we have been requested to revisit the contract. I think the goal is going to be a rolling 4-year contract. So there's a couple of years left, maybe a little bit more. And so they're looking to extend it out a couple of years. The key is, from our perspective, they need us to plan for substantially higher volumes. In order to do that, we literally have to get a brand-new building. If you recall, we brought on building 5 this year in our robotic surgery campus. We're going to have to add a sixth building. We're going to have to add new capital, new personnel, et cetera. So we need a commitment from them. And conversely, they need a commitment from us so that they can be assured of continuity of supply. In general, when we do a new contract, it does incorporate all the products, not just the Xi, it would roll in all the other ones at the same time. Simultaneous with working on that contract with Intuitive, we're going back and negotiating with our key supplier. So we'll look for our supplier to give similar commitments for volume that we do over the same 4-year period. And the volumes that are being contemplated are significantly increased over where we are now, particularly in the out years. We have the capacity already to do, I think, about 9 million drapes, but they're looking for us to plan to do substantially more than that in the out years.

Brett Fishbin: All right. Super helpful. And then maybe I'll just follow up on -- in the quarter, I think inorganic revenue was again higher than we were expecting and looking at the 12-month run rate, I think it was a little bit above \$9 million. So maybe just touch on how the acquired businesses performed versus your expectations and whether the upside relative to, call it, the trailing 12-month rate was more from the new ones, UNIPEC and TPI or from the final stub period from some of your deals from last year.

R. Bailly: So to start, both of our 2 new ones are small, but they're performing fantastically well. They're turning out to be home runs, even though they're little, both strategically by bringing us new capabilities and financially. So I would say the impact from the new acquisitions is relatively small. And so the inorganic growth you're more seeing is from the previous ones rolling forward, but we are thrilled with both of our new small acquisitions. And despite the fact that the small ones are not as impactful that we're able to -- I come up with much more pro shareholder valuations in those than we're seeing in the market for the much larger deals. So we're still happy with the small deals.

Operator: The next question comes from Max Michaelis with Lake Street Capital Markets.

Maxwell Michaelis: I want to go to -- go back to the 2 programs that are expected to ramp in 2026. I think you mentioned a \$10 million number in revenue contribution for next year. But sort of help me out, what do those 2 programs look like in terms of size, maybe once that's fully scaled, let's call it, in 2027 or 2028?

R. Bailly: Yes. So our estimate of \$10 million in my feeling is very conservative. I think one of those programs alone could be \$10 million in 2026 and the other about half that size. We're always very conservative in year 1 because we don't know if there's going to be delays in launching. But they're

both substantial greater than \$5 million programs at rate and both growing rapidly. So in the out years, one of them could be \$20 million plus within a few years and the other one harder to say, but they're both rapidly growing programs that we're super excited about. So I would take the \$10 million as conservative and then look for 2027 to be a wonderful uptick from there.

Maxwell Michaelis: Awesome. And then just with the recent discussions and the extension of your contract with Intuitive, I know you talked about sort of an investment needed in the building 6. I mean, how much are you guys in terms of investment on the hook for? Is this all on their side, I guess?

R. Bailly: It's being discussed and negotiated. They have already committed to a multimillion dollar investment that's related to improving efficiency. Some of their internal initiatives came up with some efficiencies that are helpful to us, and they share all these things with us. So they're in the process of a multimillion dollar investment right now. Typically, they're shared capital. At a minimum, we would be on the hook for investing in the leases, et cetera. I think the inclination of late is more that it would be Intuitive's capital than ours, but it has not been decided. It could be 100% either one or it could be split down the middle. In the past, we've done both. But I would expect some multimillion dollar sharing of capital in the end.

Operator: The next question comes from Cooper Andrew with Raymond James.

Noah Lewis: This is Noah on for Andrew. Just wanted to get a sense for the AJR pacing. You called out \$8 million of incremental orders this quarter, \$16 million in backlog. I think you said earlier to a question, you haven't seen any demand impact. So how should we think about you working down that backlog over the next few quarters? And should we expect AJR being able to return to growth as you see those efficiencies? And so what should we expect from kind of that nonintuitive business that's kind of major. So just get a sense there.

R. Bailly: Sure. So we are working hard to reduce that backlog. Unfortunately, there -- or fortunately, their business itself is growing. So the demand internally is growing and the backlog, as you say, is about \$15 million or \$16 million. Our goal is to work it down as fast as possible. I think that they'd like us to have it done by the end of the year. I think that's going to be a tall order. We're way more interested in output than efficiency right now. So we're throwing a lot of resources at getting their backlog down. As we go into next year, we're still expecting the business to continue to grow. So all on its own, it will grow at a double-digit rate, plus we'll be working down the backlog. So we have quite a bit of tailwind going into next year. So our goal, like I said, is to get our customers' orders fulfilled as fast as possible with less focus on efficiency. Next year, we'll turn our attention to doing things much more efficiently.

Noah Lewis: Okay. Awesome. And then just one quick follow-up and kind of following up to that point on efficiency. We've already had that labor headwind sort of troughing in 3Q and getting better from here. So now that you're sort of working -- now that you're working through all of that, how should we expect gross margins to pace going forward? I know you're lapping like the headwinds next year, but just kind of curious how should we expect margins to trend as you pull out those efficiencies in light of your LRP ranges?

Ronald Lataille: This is Ron. Noah. So yes, we would anticipate gross margins gradually improving. As Jeff mentioned in his script, the inefficiencies are not going to be 100% eliminated. They'll linger into Q4 and potentially even into Q1 of next year as we focus on output rather than efficiency. So I think they will gradually improve from where we were in Q3, but I don't think they'll be back to where sort of adjusted gross margins would have been had we had no inefficiency in Q3.

Operator: The next question comes from [indiscernible] with [AFR].

Unknown Analyst: I just want to drill on the \$8 million of orders that weren't filled in the quarter. I just -- I think you mentioned it, Ron, in your prepared remarks, but just so I'm clear, that closed July of '24, so it is considered organic this quarter year-over-year?

Ronald Lataille: It is.

Unknown Analyst: And so in a perfect world where you had delivered those, we should actually think about medical being more like \$150 million, roughly 13%, 14% growth year-over-year?

Ronald Lataille: Yes, I think that's right. To be clear, if we were able to deliver on the \$8 million of backlog, organic growth would have been approximately 6%. Factoring in the inefficiency, the \$3 million, if we were -- if we did not have that \$3 million, gross margins would have been -- adjusted gross margins would have been approximately 29.7%. EPS would have been approximately \$2.67 and

adjusted EBITDA would have been approximately \$33.7 million.

Unknown Analyst: Got it. Got it. And thinking about that EBITDA, I get that there was \$3 million of AJR costs, but I got to imagine there's costs associated with the ramp-up in the qualification programs that you guys were getting started in the quarter?

R. Bailly: Yes, 100%. Every program launches with losses and then transitions to breakeven and then to profitability. So the programs launching in the DR are still in the losses phase and the programs launching in La Romana will be in the losses phase for the first quarter or 2.

Unknown Analyst: I mean, how would you -- can you size that for us? Or how should we think about that? It's just -- I'm trying to -- obviously, you guys -- you punched above your weight in the quarter with a lot going on. And I'm trying to kind of dig at what would be a good -- how should we kind of view I don't know, lack of a better term, run rate EBITDA? And I get it, \$30.7 million of EBITDA, add \$3 million and then you have these onetime costs. How big are those roughly?

R. Bailly: I mean for us, it's the cost of doing business because we're constantly launching programs, so we usually don't quantify them. It's -- per program, it's not millions of dollars, but it's hundreds of thousands of dollars per program. But again, we're used to this. We factor it into our planning. So we're constantly launching programs and constantly absorbing modest losses. But those several hundred thousand dollars of losses will turn into profits over the next couple of quarters. So it will be meaningful, but it's just the cost of doing business for us.

Unknown Analyst: And I know you guys talked about obviously wanting to serve the customer, getting that product out the door, not worrying so much about efficiency. But is it fair to assume the incremental margin on that additional \$8 million probably would have been something a little greater than 20% or in that 20% to 25% range?

R. Bailly: We would probably think of it more as contribution because all the fixed costs are kind of there, the rent, the engineers and everything. So the contribution is considerably higher than that when you subtract direct costs.

Ronald Lataille: Yes, [indiscernible], it's probably in the 30% to 35% range.

Unknown Analyst: So I mean, we should be thinking about it in a perfect quarter where none of this stuff happened, you're actually kind of run rating more like a \$36 million, \$37 million of EBITDA.

Ronald Lataille: I think that's right.

Operator: This concludes our question-and-answer session. I would like to turn the conference back over to Jeff Bailly for any closing remarks.

R. Bailly: Yes. Thank you all for your participation and interest in UFP. As you can tell, we are super bullish about our future, particularly on the long-term front for robotic surgery. We will work our way through this onetime AJR issue. We have, for the first time in the history of our company, actually filed a claim after doing 20-something deals for a miss on a rep and warranty. So maybe or maybe not, we'll get reimbursed for our expenses. But one way or another, they're onetime in nature. We'll move through them. We're working through them quickly. So we appreciate your patience in the process, and we appreciate your interest in the company.

Operator: Thank you. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.

R. Bailly: Thank you, everyone.