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Problem child's redemption

James Robertson, Jr. writes:

In the past two months, the House and Senate appropriations committees issued a rare rebuke to President Donald Trump. Defying orders to slash funding for medical research by 40%, the lawmakers voted instead to raise the base budget for the National Institutes of Health by roughly 2%. You had to read the news twice to believe it.

The S&P Health Care Index, suffering from a kind of long Covid, trades at a 26% discount to the broader index on a price-earnings basis. It's the cheapest it has been by that criterion since 2009. The bear market in health care hit few harder than the laboratory-supplier Avantor, Inc. (AVTR on the New York Stock Exchange). The market has severely underpriced a recovery, we are about to contend.

You can think of Avantor as a life-sciences tool company. It makes and distributes consumables, chemicals and equipment used across a variety of pharmaceutical and research facilities. Its laboratory solutions (LS) segment delivered 68% of last year's revenues from products that range from simple pipettes to ultralow-temperature freezers.

Bioscience production (BP), which contributed the rest of Avantor's 2024's top line, is the specialized and higher-margin segment. It manufactures the building blocks—buffers, solvents, excipients and stabilizers—behind advanced biologics like GLP-1s and monoclonal antibodies. Beyond pharma, it also furnishes the health-care, semiconductor, aerospace and defense industries with complex chemicals and materials.

The lab-supplier business has been his-

torically stable and cash-generative. Well and good, the bears reply, but Avantor's management has promised much and delivered little. It has cut its guidance twice in the year to date, most recently projecting revenues and earnings to slip by 1% and 3%, respectively. As recently as last December, it had projected growth of 2% and 7%. A turnaround in a soft market would be no easy feat even without the White House micromanaging drug prices, medical research, international trade and what have you. A presidential whim could wreck an upswing.

So far, Avantor's competitors have managed to protect margins and grow share even as our pick-to-click has watched its operating margin drop to 7.7% from 13.7% in the second quarter of 2021. Has Avantor simultaneously relinquished market share? Management neither confirms nor denies. As its financials deteriorated, the company waved away at least one lifeline in the shape of a buyout offer.

Beyond poor management, bears argue that Avantor cannot compete effectively against such larger entities as Thermo Fisher Scientific, Inc. and Danaher Corp. It is a disability inherent in Avantor's position in more commoditized and less defensible product lines, they say.

Whether or not the shares are cheap (as we contend), they are certainly cheaper. Quoted at a ratio of enterprise value to trailing Ebitda of 8.4:1, they have fallen by 72% from their 2021 peak and trade at a 60% discount to industry peers. Expectations sit so low that a return to the customary haircut of 25% would imply a near doubling of the current share price.

A little-regarded stock in a neglected industry group, Avantor affords an inves-

tor two ways to gain. Either the company can get back on its feet or the industry can. "Frankly," Paul Knight, managing director at KeyBanc Capital Markets and an AVTR bull, tells me, "I think there are more catalysts out there for Avantor than for about any company in the life-sciences sector."

The Street is mildly bullish on AVTR, with 9 buys, 12 holds and no sells. Bears are cautious at this valuation; short interest amounts to 4.4% of the float. Insiders, meanwhile, have bought a net 207,243 shares at a cost of \$2.55 million in the past 12 months. On Aug. 21, Gregory Summe, a member of the board, laid down \$1.3 million to secure 100,000 shares.

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The Avantor assemblage traces its roots to the East and West coasts of 19th-century America. A true forty-niner, John Taylor soon discovered that selling pick-axes was more profitable than swinging them. By 1883, his catalog spanned 127 pages of chemicals, mining and laboratory equipment. Around the same time, John Townsend Baker started brewing high-purity acids and reagents in a shack that was a stone's throw from Lafayette College in Easton, Pa. Dissatisfied with impure European imports, the chemistry student decided to formulate a home-grown brand of chemicals in 1882.

In 2017, the legacy operations of the two Johns merged. The chemical producer Avantor bought the distributor VWR International to create the second-largest life-sciences catalog in the industry. Avantor's private-equity owners, New Mountain Capital, had arranged the marriage and made plans for an IPO.

Two years later, Avantor began trading on the New York Stock Exchange.

The timing was ideal. A global pandemic supercharged demand for the tools of the health-care complex. In 2020, free cash flow surged by 187%. Venture capital flooded into early-stage biotech companies, drugmakers ramped up production and customers packed their warehouses with Avantor's products. By 2023, all those winning trends had reversed. And they show little positive movement more than two years later.

The most recent round of quarterly earnings has given investors hope that the health-care market has hit a bottom. Thermo and Danaher both have raised their outlooks, citing rebounding demand, especially for bioprocessing supplies. Not Avantor, though—as noted, it has lowered its outlook.

But with half the market cap it had a year ago, the board has sprung into action. It reshuffled the front office, replacing the CEO and the head of the laboratory division this summer. Not waiting for the new chief to report for work, Engine Capital Management, L.P. launched an activist campaign, announcing a 3% stake in the company and issuing a broadside against the board and prior management. Heal thyself or sell thyself, Engine concludes its public letter.

Whether the current Avantor business model makes sense is a question for the new management and Mr. Market to decide. There are certainly bidders for the company's assets. In June 2023, industrial conglomerate Ingersoll Rand, Inc. approached Avantor about a buyout, court documents show. In fact, Engine claims, it has uncovered another such overture to Avantor, and it reckons a buyout today would fetch a 42–58% premium to the current share price.

The boom-bust cycle and managerial missteps have obscured Avantor's value. Across its end markets, the company is among the top three suppliers in its main product lines: lab consumables, bioprocessing ingredients and high-purity silicone. And given strict regulations and high switching costs, revenues tend to stick. Some 85% of the top line is recurring, management related at year end.

When producing pills and therapies, pharma companies are risk-averse. After all, a single impure component can derail a production run. Once a drugmaker specifies the ingredients of a treatment, it rarely changes the recipe voluntarily, as doing so often launches a regulatory



source: The Bloomberg

hearing. Among Avantor's proprietary products, roughly 90% are ingrained in customer formulations and operations. No one dislikes stable and dominant product lines.

Divestiture is among the options on the table of remedial corporate action. It would not be without precedent. Late last year, Avantor sold its clinical service division to Audax Private Equity for \$650 million. The company's NuSil silicone brand, while fast-growing, draws capital and management attention away from its pharma franchise to noncore industrial markets. Another option would involve breaking up the distribution and manufacturing lines of the business, leaving Avantor to focus on expanding its bioscience-materials division.

Some longer-term investors, though, see more value in keeping Avantor in one piece. "As much as we'd love a short-term pop in the portfolio," Christopher Pavese, president and chief investment officer of Broyhill Asset Management, tells me, "if Avantor can get their story straight and start executing, I think the long-term value is significantly greater than if they sell." As both a manufacturer and distributor, Avantor has clear synergies to fill its shelves with its own products. And while low-margin, its distribution segment throws off a lot of cash, which management can reinvest in new product lines.

Avantor produces one of the largest internationally distributed catalogs in life sciences. Only Thermo and Merck KGaA (not to be confused with its American

cousin Merck & Co., Inc.) can meaningfully compare on a worldwide scale. Because regional minnows largely populate the rest of the market, Avantor still has room to grow, either by taking share from smaller competitors or winning it from the other two majors.

There are clear, though demanding, paths to close the gap with its competitors. The inefficient distribution business is a good place to start. In that segment, at last report, Avantor earned adjusted Ebitda margins of 11.8% versus 16.3% for Thermo.

Inventory management is another opportunity. "In 2024," analysts at Engine Capital write, "Avantor reported approximately \$6.8 billion of revenue on roughly 6 million stock keeping units, or around \$1,150 per SKU. In contrast, Thermo's Research and Safety division achieved revenue of approximately \$6.4 billion on just 2.5 million SKUs, or around \$2,600 per SKU. This disparity suggests that Avantor may carry a large number of redundant or slow-moving SKUs.... Concentrating purchases among fewer vendors could improve inventory turns, boost volume-based rebates and strengthen margins."

Taking on that task is Corey Walker, an old hand who left Avantor in 2020 to lead another health-care supplier, ILC Dover. After Ingersoll Rand bought ILC last year for 17 times adjusted Ebitda, Walker returned to Avantor to lead its LS division and conduct a strategic review of the business. The new CEO, Emmanuel Ligner, previously helmed the bioscience

division at Danaher, where he unified the GE and Pall Corp. life-sciences brands under the Cytiva banner. Investors are betting on Ligner to advance the bioscience division and streamline it with LS.

The biologics market is expected to grow 10% a year over the next decade, according to Precedence Research. Avantor's bioscience wing, with 2024 adjusted margins of 25.7%, is in line to benefit from growth in more resource-intensive pharmaceuticals. "This is really the gem of the business," Scott Rodgers, senior analyst at Voss Capital, L.P., tells me. "This is where the growth should really show up."

But at today's valuation, the market assigns little to no value to the bioprocessing business. Trading below VWR's historical EV-to-forward-Ebitda multiple of 12 times, Avantor, at 11 times, carries the multiple of a pure-play distributor. "As a result," Rodgers relates, "we

think there's a large enough margin of safety here."

Expanding its share of white-label products offers another avenue to higher profitability. Proprietary products made up 53% of revenue at year end, a figure unchanged since 2019. Operational imprudence played its part in the non-seizure of this obvious opportunity, but so did private-equity-style leverage. After swallowing VWR in 2017, Avantor carried net debt greater than 9 times trailing Ebitda. Debt service chewed through a significant share of free cash flow, foreclosing many managerial options, including expanding its private-label offerings, particularly bioprocessing materials.

Now, six years after its IPO, the double-B-rated Avantor has nearly completed the task of cleaning up its balance sheet. At last report, it carried a ratio

of net debt to Ebitda of 3.2, just a hair above its target of 3.0. "They are well past any balance-sheet issues," Knight tells me. "They have \$600 million to \$700 million of annual free cash flow available to them now." Next year, analysts project that debt service will eat 24% of free cash flow, a far cry from the 146% feast in 2019.

With that new flexibility, the front office can buy back shares at depressed prices or add new products to its catalog. "They've got levers now they can pull," Pavese tells me, "and so you've got plenty of optionality there. And at this valuation, the upside if they get it right is tremendous." Given that pharma companies may lose \$183.5 billion of revenue by 2030 as their patents expire, Avantor looks well positioned to capitalize on a boom in research and manufacturing.

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