Research Update:

Germany-Based Pharma Firm Cheplapharm Arzneimittel GmbH Affirmed At 'B'; New Debt Rated 'B'; Outlook Stable

October 5, 2020

Rating Action Overview

- Off-patent branded pharmaceutical company Cheplapharm Arzneimittel GmbH (Cheplapharm) intends to issue €1 billion of senior secured notes to secure the acquisition of four product portfolios.
- We expect those products to significantly increase the scale of Cheplapharm's EBITDA, to about €580 million-€600 million in 2021, from our expectation of about €330 million-€350 million in 2020, and to improve the diversification by products sold and geographies covered.
- We are affirming our 'B' long-term issuer credit rating on Cheplapharm, on its existing term loan B, and on its existing senior secured notes, and assigning our 'B' issue rating to the proposed €1 billion senior secured notes.
- The stable outlook indicates that we expect the company's disciplined acquisition strategy to enable it to successfully integrate the targeted assets. That said, we see limited headroom for integration setbacks or additional discretionary debt-funded acquisitions over the next 12 months, at the current rating.

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Rating Action Rationale

The planned series of acquisition could significantly increase Cheplapharm's scale and product diversification. The firm plans to acquire four portfolios of products in the fourth quarter of 2020. We expect these new products will significantly increase the scale of Cheplapharm--the company's EBITDA is forecast to grow to about €580 million-€600 million in 2021. We forecast it would be about €330 million-€350 million in 2020. Additionally, this series of acquisitions will likely improve Cheplapharm's product portfolio diversification. Once the new products have been integrated, the Top 5 products should contribute only about 27%-29%, rather than about 40%-42%, as they did in the first half of 2020.

We expect Cheplapharm's disciplined buying strategy will enable it to integrate the portfolios of products it is acquiring, despite some execution risk. The integration of new assets carries execution risks associated with the need for the timely transfer of marketing authorizations (MA), the seamless integration of products in Cheplapharm's network of contract manufacturing organization, and the realization of targeted gross margins from new products. That said, Cheplapharm has taken a proactive approach to increasing its staff count, to 364 in June 2020from 321 in December 2019, which should help it manage the transfer of MAs for the new products in each country. We take into account Cheplapharm's successful track record of transferring MAs and integrating acquired drugs into its network of manufacturing partners within the timeframe it has agreed with the seller. Moreover, Cheplapharm has historically been disciplined regarding the price it has paid for new products. It has also been careful to acquire branded products that do not require marketing efforts to realize the expected gross profit. We expect Cheplapharm to continue applying its disciplined acquisition policy and therefore manage execution risks.

We anticipate that Cheplapharm will continue to generate substantial free operating cash flow (FOCF) thanks to its strong profitability and limited capital expenditure (capex) requirements. Cheplapharm operates with an asset-light business model focused on a buy-and-build strategy. The company primarily focuses on acquiring the right target and subsequently outsources manufacturing, distribution, and marketing activities to its external networks. Additionally, the company does not have in-house research and development costs. Cheplapharm primarily implements its experience of managing product life cycles. This results in strong profitability and we anticipate an S&P Global Ratings-adjusted EBITDA margin of 48%-53% over the next 12-18 months. Given the asset-light business model and our expectation that the company will continue to manage its working capital requirements well, we project that it will generate annual FOCF of €220 million-€250 million over the same period. We also assume that the company will utilize internally generated cash for future acquisitions.

We expect Cheplapharm's financial policy of using external debt and internally generated cash to finance the acquisition of new drugs is likely to result in debt-leverage ratios of about 5.0x, on average. Cheplapharm's product portfolio primarily comprises niche and older legacy products that have lost their patent protection. These products are exposed to price erosion and their revenue declines naturally by 3%-5% a year. The business model solely focuses on sourcing assets from outside, financed by internally generated liquidity and external debt. In our view, Cheplapharm's geographic diversification and positive track record in transferring MAs makes the company a preferred partner for large pharmaceutical companies and gives it an advantage in the bidding process. We expect that the company will continue to use a combination of internally generated cash and external debt to acquire new products and offset the natural decline in revenue. As such, we forecast that Cheplapharm's debt-leverage ratio is likely to continue to average 5.0x-5.5x.

Outlook

The stable outlook indicates that Cheplapharm's operating performance is likely to remain resilient. The company is forecast to generate EBITDA margin of about 48%-53% in the next 12-18 months, reflecting a seamless integration of new assets. We forecast that Cheplapharm will generate EBITDA of about €580 million-€600 million and annual FOCF of about €220 million-€250 million in the next 12-18 months. Given the large amount of debt when the transaction closes, we

expect Cheplapharm to continue generating substantial annual FOCF under the current rating.

Downside scenario

We could lower the rating if we observe a deterioration in Cheplapharm's operating performance, such that its ability to generate substantial annual FOCF is affected or it cannot improve its debt-leverage ratio within the 12-18 months following the latest acquisition. This would most likely occur if Cheplapharm acquired a portfolio of drugs at high EBITDA multiples, or if it faces setbacks in integrating the new assets.

Our downside scenario comprises the following triggers:

- Annual FOCF of below €200 million; and
- Inability to reduce adjusted debt-to-EBITDA ratio to about 5.0x within the 12-18 months after the latest acquisition.

Upside scenario

We could consider an upgrade if the company successfully achieves a substantial improvement in scale and diversity, such that declining sales from individual products had a diminishing effect and newly acquired products contributed a smaller share of the overall. This would most likely occur if recent acquisitions were seamlessly integrated and the company continued to apply a disciplined acquisition strategy. Under this scenario, we would expect Cheplapharm to maintain its high level of profitability and cash-flow conversion, in line with historical trends.

Our upside scenario comprises the following triggers:

- Adjusted EBITDA margin of about 50%-55%;
- FOCF sustainably exceeding €250 million; and
- Adjusted debt-to-EBITDA ratio sustainably remaining below 5.0x.

Company Description

Cheplapharm is a Germany-based off-patent branded pharmaceutical company. It reported revenue of €524.8 million and S&P Global Ratings-adjusted EBITDA of €277.5 million in 2019.

The company mainly acquires intellectual property rights from pharmaceutical companies after the respective products have run out of patent protection, but while they still demonstrate relatively stable revenue. Cheplapharm operates with an asset-light business model focused on a buy-and-build strategy. Primarily, the company identifies the right target, outsources manufacturing, distribution, and marketing by utilizing contract manufacturing organization and external networks; and implements its experienced life-cycle management activities to optimize the process.

Our Base-Case Scenario

- Revenue to reach €680 million-€690 million in 2020 and to increase to €1,145 million-€1,165 million in 2021. Revenue growth will likely come from the integration of recent and upcoming acquisitions.

- Adjusted EBITDA margin of 48%-53%, thanks to Cheplapharm's asset-light business model and focus on life-cycle management.
- Working capital requirements of about €55 million in 2020 and about €200 million in 2021, reflecting the integration of inventories for acquired products.
- Limited annual capex requirement of €5 million-€10 million.
- FOCF of about €220 million-€250 million in 2020 and 2021.
- No dividend paid, in line with Cheplapharm's financial policy.

Key metrics

Based on the above assumptions, we arrive at the following credit metrics:

- Adjusted debt to EBITDA of about 5.0x-5.5x on average and in the absence of significant debt-funded acquisition; and
- Fund from operations (FFO) cash interest coverage of 5.5x-6.5x in the next 12-18 months.

Our adjusted debt includes the €980 million term loan B4, €500 million senior secured notes, €1.0 billion proposed senior secured notes, and €30 million as a shareholder loan. We do not deduct available cash.

Liquidity

We view Cheplapharm's liquidity as adequate, indicating that sources of cash will cover uses by at least 1.2x over the next 12 months. Even if EBITDA were to decline by 15%-20%, we forecast that net sources of liquidity would remain positive. We assess the liquidity position on an ongoing basis and, as such, we do not include the one-off effect of the debt-funded transaction.

We anticipate that Cheplapharm's liquidity sources over the next 12 months will be:

- €105 million of available cash as of June 2020;
- €450 million available revolving credit facility (RCF); and
- €360 million-€380 million positive cash FFO.

We anticipate that Cheplapharm's liquidity uses over the next 12 months will be:

- €100 million-€150 million of working capital to integrate the inventories for acquired product portfolios; and
- €5 million-€10 million of annual capex.

Covenants

The senior facility agreement includes a springing covenant tested quarterly when 40% or more of the RCF is drawn. Under this covenant, the net senior secured leverage ratio is limited to 6.0x.

Moreover, the debt documentation includes an incurrence covenant that prevents Cheplapharm from making acquisitions that would bring its net senior secured leverage ratio above 4.5x, after taking into account any pro forma effects and anticipated synergies from acquired products.

In our base case, we expect Cheplapharm to maintain adequate headroom under its financial covenants.

Issue Ratings - Recovery Analysis

Key analytical factors

- The senior secured €980 million term loan B4 due 2025, and the €500 senior secured notes due 2027 have an issue rating of 'B' and a recovery rating of '3'. This indicates recovery prospects of 50%-70% (rounded estimate: 50%).
- We assigned an issue rating of 'B' and a recovery rating of '3' to the proposed €1.0 billion senior secured notes due 2028, based on our indicative recovery prospects of 50%-70% (rounded estimate: 50%).
- In our hypothetical default scenario, we assume a lack of target products available at accessible prices and an increase in price pressure.
- We value Cheplapharm as a going concern, given its well-established branded generics position and its well-diversified portfolio in geographical terms.

Simulated default assumptions

- Year of default: 2023
- Jurisdiction: Germany

Simplified waterfall

- Emergence EBITDA: about €261 million
- Capex represents 0.5% of sales
- 0% cyclicality adjustment
- 80% operational adjustment was used to reflect the low capex requirement, high profitability, and cash flow conversion
- Multiple: 6.0x
- Gross recovery value: about €1,566 million
- Net recovery value for waterfall after admin expenses (5%): about €1,488 million
- Estimated senior secured debt: about €2,935 million*
- Recovery range: 50%-70% (rounded estimate: 50%)
- Recovery rating: 3

*All debt amounts include six months prepetition interest.

Ratings Score Snapshot

Issuer credit rating: B/Stable/--

Business risk: Weak

- Country risk: Intermediate
- Industry risk: Low
- Competitive position: Weak

Financial risk: Highly leveraged

- Cash flow/Leverage: Highly leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Pharmaceutical Industry, April 8, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Ratings Affirmed	
Cheplapharm Arzneimittel GmbH	
Issuer Credit Rating	B/Stable/--
Senior Secured	B
Recovery Rating	3(50%)
New Rating	
Cheplapharm Arzneimittel GmbH	
Senior Secured	B
Recovery Rating	3(50%)