RATING ACTION COMMENTARY

Fitch Affirms Cheplapharm's Senior Secured Debt at 'BB-'/'RR3' after Bond Placement

Fri 16 Oct, 2020 - 8:32 AM ET

Fitch Ratings - Frankfurt am Main - 16 Oct 2020: Fitch Ratings has affirmed CHEPLAPHARM Arzneimittel GmbH's Long-Term Issuer Default Rating (IDR) at 'B+' with a Stable Outlook following announcement of the acquisition of several drug portfolios. Fitch has also affirmed Cheplapharm's senior secured debt rating at 'BB-'/'RR3' based on the final terms of the new senior secured notes of EUR575 million and USD500 million due in January 2028 (the Transaction).

Cheplapharm's IDR reflects its niche yet growing and scalable asset-light business model with strong operating and cash flow margins. The company's aggressively debt-funded buy-and-build strategy is balanced by a disciplined execution of product rights acquisitions translating into funds from operations (FFO) leverage averaging about 5.5x through to 2023, which is in line with the rating.

The Stable Outlook reflects our expectation that the company will maintain the quality and risk profile of its product portfolio by investing all its internally generated cash flows into new IP rights while applying consistent acquisition and financial policies, which will facilitate a stable operating and financial profile.

KEY RATING DRIVERS

Debt-Funded Acquisitions Rating Neutral: We regard the announced debt-funded addition of several drug portfolios as rating neutral. This also includes the purchase of additional international rights for USD400 million, which were not part of the Transaction, but which were reflected in Fitch's rating case as part of our assumed annual acquisition basket for additional opportunistic M&A and therefore covered by the rating headroom available under the 'B+' IDR.

Furthermore, all these acquisitions show consistent economics adherent to Cheplapharm's acquisition criteria, and therefore enhance operating performance sufficiently to ensure a stable financial risk profile despite the increasing debt. A strict adherence to conservative acquisition multiples remains a key factor underpinning the rating and its Stable Outlook as the company implements its ambitious growth strategy.

Improving Scale and Diversification: The period of strong acquisitive growth has translated into receding product-concentration risks as shown in a projected lower contribution from the top three products to below 25% after the transaction in FY20 from 40% in FY19. The company also has broad presence in more than 120 countries, which further mitigates individual product risks.

Moderate Execution Risks: We view the execution risks as moderate due to an extended period of uninterrupted rapid, largely debt-funded, growth. We expect the business to double in size between FY19 and FY21 with sales projected to reach EUR1.2 billion and EBITDA to reach EUR600 million. However, the company remains engaged in the integration of recently made acquisitions.

The increased execution risks are mitigated by Cheplapharm's record of strong operating performance, improved cash generation, disciplined approach to asset selection and adapted corporate structures to deal with increased business volumes.

Defensive Operations: The ratings are underpinned by Cheplapharm's defensive business profile, characterised by well-executed acquisitions of drug IP rights and active product life-cycle management. We take a positive view of Cheplapharm's highly visible and predictable revenue, and limited exposure to competition, despite expected gradual sales erosion as the company's drugs approach the final stage of their economic life.

OTC Products Rating Neutral: We view the recent addition of over-the-counter (OTC) drugs as part of larger portfolios as rating neutral despite their higher embedded market risks. This is due to the low expected share of OTC drugs in the company's portfolio

benefitting from a pull effect from doctors and patients, which will not require higher marketing spend, with the riskiness of these OTC products broadly comparable to Cheplapharm's existing legacy drugs.

We therefore think the acquisitions contribute to an overall improved business risk. Increasing riskiness of asset additions could lead to a higher business risk and, together with less disciplined execution and financial policies, could put pressure on the rating.

Healthy Operating Profitability: Cheplapharm ranks among the most profitable credits in Fitch's low speculative-grade portfolio in the sector, with EBITDA margins projected at about 50% until 2023. This provides strong support to Cheplapharm's credit profile. We expect healthy profitability to be maintained, given the company's ability to continuously add margin-accretive products, which could be funded from internal cash flows in combination with the sizeable revolving credit facility (RCF) to be increased to EUR450 million as part of the Transaction.

Strong Free Cash Flow: We estimate that the acquisitions will facilitate a further increase of free cash flow (FCF) from about EUR130 million in FY19 to EUR250 million in FY22-FY23, with FCF margins sustained at 20%, which is high for the rating. In our view, the high FCF margins support a stable business risk profile, balancing gradually declining earnings from its existing niche and legacy products with the addition of new IP rights.

We do not expect FCF to be used for debt reduction, but we see little risk of dividends given the founders' long-term commitment to the business. We view reinvestment of significant FCF into the business in line with Cheplapharm's acquisition policy as a key factor in supporting the IDR at 'B+' in the absence of commitment to deleveraging.

Appropriate Leverage: We project FFO leverage to remain within the sensitivities at about 5.5x. Our leverage and rating considerations are supported by the expectation of continuously strong and stable operating performance, which, in addition to an active portfolio management, come as a result of a disciplined approach to M&A in terms of acceptable asset valuation and operating profitability levels of the acquired products.

More Debt-Funded M&A Expected: We assume continuous use of the RCF in combination with FCF during FY21-FY23 to fund further M&A estimated at EUR250 million a year as Cheplapharm looks to sustain and grow its product portfolio. However, given ample supply of off-patent drug acquisition opportunities offered by big pharmaceutical companies, we will see more debt-funded M&A in excess of EUR1 billion a year. The rating remains

exposed to the quality of targets and acquisition execution as we do not assume debt-financed event risks beyond the committed debt funding.

Aggressive Financial Policy: We expect the company to continue its aggressive growth trajectory, prioritising inorganic growth over deleveraging. The existing senior secured term loan and the new senior secured notes in this regard offer weak creditor protection given the absence of maintenance financial covenants. The company's ability to repeatedly raise incremental debt increases the risk of re-leveraging, particularly should the company change its acquisition and financial policies.

DERIVATION SUMMARY

We rate Cheplapharm applying our Ratings Navigator framework for pharmaceutical companies. The IDR reflects Cheplapharm's defensive business profile with resilient and predictable earnings, as well as high operating margins and strong cash flow generation due to the company's asset-light business model.

Cheplapharm is rated at the same level as Antigua Bidco Limited (B+/Stable) as they share high and stable operating and cash flow margins, and similar business models and product portfolio management. We regard both companies as having structurally similar operating risks and comparable financial risk profiles despite Antigua Bidco's smaller scale, more concentrated product portfolio and slightly different approach to new product evaluation, with FFO-adjusted gross leverage at about 5.0x, which translates into their 'B+' IDRs.

We see Cheplapharm's credit profile as stronger than that of the specialist pharmaceutical company IWH UK Finco Ltd (B/Stable) as warranting a one-notch difference. The rating differential reflects the former's higher operating and cash flow margins, in combination with a more conservative financial profile reflected in an FFO leverage of 5.0x-5.5x against IWH's 5.5x-6.0x.

We also regard Cheplapharm as being a stronger credit than generics producer Nidda BondCo GmbH (B/Stable), despite its much smaller scale and more concentrated portfolio, which are mitigated by wide geographic diversification within each brand. Nidda BondCo's rating is burdened by high leverage, with a spike in expected FFO adjusted gross leverage to 8.7x in 2020 following the recent debt-funded acquisitions, which we project to return to below 8.0x in the medium term.

KEY ASSUMPTIONS

- Revenue growth of 88% in 2021 driven by acquisitions, decelerating to a flat growth thereafter.

- EBITDA margins at about 50% in 2020 and gradually declining to about 47% in 2023.

- Maintenance capex of EUR3 million-EUR7 million a year from FY20.

- About EUR420 million of IP rights purchased in 2020 followed by about EUR1.2billion in 2021. We project the larger drug portfolios that are being funded with new senior secured notes to take place in January 2021 in addition to opportunistic acquisitions of EUR250 million a year during 2021-2023 including estimated milestone payments arising from recently completed acquisitions. Funding for these opportunistic acquisitions is assumed to be a combination of FCF and RCF drawdowns based on average enterprise value/sales acquisition multiple of 3.0x.

- Fitch forecasts the new senior secured notes will be issued in early 2021 with the payments for the announced acquisitions expected to be completed by end-2020 also made in early 2021.

- Trade working capital outflows of EUR290 million in 2021 followed by EUR170 million in 2022 and EUR150 million in 2023 driven by product additions and stock purchases following transfer of product marketing authorisations on a country-by-country basis.

- No dividend payments.

RECOVERY ASSUMPTIONS:

In a distressed scenario, Cheplapharm would most likely be sold or restructured as a going concern rather than liquidated given its asset-light business model.

- We estimate a post-restructuring EBITDA at about EUR360 million. Cheplapharm would be required to address debt service and fund trade working capital as the company takes over inventories following transfer of market authorisation rights, as well as to make smaller M&A to sustain its product portfolio to compensate for a natural sales decline. This EBITDA represents an about 45% discount to Fitch's estimated post-acquisition EBITDA of about EUR640 million in 2021, which will reflect the full-year contribution from all recent acquisitions.

- Fitch applies a distressed enterprise value/EBITDA multiple of 5.5x (unchanged), reflecting the underlying value of the company's portfolio of IP rights.

- After deducting 10% for administrative claims, our principal waterfall analysis generated a ranked recovery in the 'RR3' band for the first-lien senior secured facilities including the new senior secured notes equivalent of EUR1 billion and an increase of RCF to EUR450 million indicating a 'BB-' instrument rating. The waterfall analysis output percentage on current metrics and assumptions is 60%.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- An upgrade to the 'BB' rating category would require a maturing of Cheplapharm's business risk profile, characterised by a sustained improvement of business scale with sales above EUR1 billion in combination with a more diversified product portfolio, resilient operating and strong FCF margins, and reducing execution risks.

- Conservative FFO leverage at about 4.0x.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Unsuccessful management of individual pharmaceutical IP rights leading to material permanent loss of income and EBITDA margins declining towards 40%;

- Positive but continuously declining FCF; and

- FFO leverage sustainably above 6.0x (net of readily available cash: 5.5x), signalling a more aggressive financial policy.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and

worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity: Cheplapharm's strong internal FCF generation, which we estimate at EUR160 million in 2020 and increasing to EUR250 million by 2023, will be sufficient to fund further portfolio expansions and maintain year-end cash at EUR20 million-40 million. Organic liquidity will be further supported by access to a committed RCF of EUR450 million, up from EUR310 million following the completion of the Transaction and long-dated debt maturities spread between July 2024 and January 2028. We estimate most of the cash will be used to acquire IP rights, rather than for debt reduction.

In our assessment of freely available cash, we deduct EUR10 million of minimum liquidity required for operations in 2020 and EUR20 million in 2021-2023, as the business gains scale.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY/DEBT	RATING			RECOVERY	PRIOR
CHEPLAPHARM Arzneimittel GmbH	LT IDR	B+ Rating Outlook Stable	Affirmed		B+ Rating Outlook Stable
• senior secured	LT	BB-	New Rating	RR3	
• senior secured	LT	BB-	Affirmed	RR3	BB-

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APPLICABLE CRITERIA

Corporates Notching and Recovery Ratings Criteria (pub. 14 Oct 2019) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 01 May 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v7.9.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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CHEPLAPHARM Arzneimittel GmbH	EU Issued

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