Fitch Ratings

Fitch Assigns Cheplapharm First Time IDR 'B+'; Senior Secured Facilities 'BB-(EXP)'

Fitch Ratings - London - 05 June 2019:

Fitch Ratings has assigned German-based pharmaceuticals company Cheplapharm Arzneimittel a first-time Long-Term Issuer Default Rating (IDR) of 'B+' with Stable Outlook. It has also assigned an expected 'BB-(EXP)'/'RR3' rating to the company's senior secured facilities comprising a term loan B (TLB) and a revolving credit facility (RCF). The assignment of final rating is contingent on the receipt of final documents conforming to information already received.

The 'B+' IDR reflects Cheplapharm's niche operations with a concentrated product portfolio. It also reflects a scalable asset-light business model with strong operating and cash flow margins and adequate financial profile with funds from operations (FFO) adjusted gross leverage of around 5.0x. The Stable Outlook encapsulates Cheplapharm's underlying ability to sustain the company's business model by investing internally generated cash into new IP rights, thus sustaining its product portfolio and maintaining a balance between legacy and new products.

Key Rating Drivers

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 low exposure to competition, despite gradual sales erosion as the company's drugs enter the final stage of their economic life.

The business model relies on active value management of IP rights, as well as a continuous addition of new products to sustain the value of the product portfolio. We view both organic and acquisitive aspects of the IP rights portfolio management as carrying low-to-moderate execution risks. This is evident in Cheplapharm's strong trading performance, although we see growing operational complexity stemming from the fast pace of acquisitive growth.

Moderately Rising Execution Risks: Execution risks have increased moderately due to an extended period of uninterrupted rapid, largely debt-funded, growth. A marked business expansion to EUR291 million in 2018 from EUR80 million in revenue in 2015 with a simultaneous increase in EBITDA to EUR165 million from EUR38 million, in combination with sustainably strong margins, points to a well-executed business strategy with a focus on disciplined asset selection and integration. At the same time this accelerated growth requires greater resource allocation and management to ensure a consistent quality of product selection and integration, while the company operates on a leveraged capital structure.

Healthy Operating Profitability: With EBITDA margins projected at around 50% over the next four years, the company ranks among the most profitable in Fitch's low non-investment grade portfolio. We expect these healthy profitability levels will be maintained given Cheplapharm's ability to continuously add new products, which could be funded from internal cash flows and/or by using a committed RCF of EUR310 million.

Strong Cash Conversion, FCF Generation: We project free cash flows (FCF) at or above EUR 100 million a year up to 2022. This, in our view, would be sufficient to ensure sustainability of Cheplapharm's operations in balancing the gradually declining earnings contribution from legacy products with the addition of new IP rights. Although we do not expect free cash flow (FCF) to be applied towards voluntary debt reduction, we equally see little risk of value being taken out of the business in form of dividend given founders' long-term commitment to the business. We therefore view FCF as a key factor in supporting the IDR at 'B+', mitigating scale and concentration risks.

Aggressive Financial Policy: Cheplapharm's extensive growth strategy has been funded largely with debt. At the same time, the currently placed TLB issue of EUR150 million with loosening underwriting standards offers weaker creditor protection with no maintenance financial covenants and the ability to repeatedly raise incremental debt. We regard such debt-biased financial policy and limited credit protection in the documentation as aggressive, resulting in the risk of further accelerating leverage, particularly given rising execution risks in a fast-growing company.

Concentrated Portfolio, Albeit Slowly Improving: The period of rapid growth has translated into gradually receding product concentration risks, although projected contribution from to the company's top three products at 37% (42% in 2018) remains material, even in comparison with other low-speculative grade peers. This concentration risk could lead to a permanent material loss of revenue, earnings and cash flows in case of an individual product failure. This is, however, somewhat mitigated by the products' wide geographic distribution.

Leverage Aligned With Rating: We view the FFO adjusted gross leverage of around 5.0x as appropriate for the rating, both against peers' as well as in the framework of Fitch's Ratings Navigator for Pharmaceutical Companies. Given the company's desire to further grow and diversify, in our analysis of the financial risk profile, we have assumed the full and gradual drawdown of the RCF between 2020 and 2022. Assuming a disciplined and targeted approach to M&A, we expect this will lead to a balanced operating and financial contribution from the acquisitions to the company's credit profile.

Ratings Constrained by Scale: The ratings will remain confined to the 'B' rating category by a lack of scale. Although the buy-and-build strategy pursued by the founding shareholders has led to accelerated business growth, it will likely take several years before the business can reach some sector relevance, even on a national scale, with revenue exceeding EUR 1 billion. We therefore do not envisage an upgrade in the medium term.

Derivation Summary

We approach Chelplapharm's rating analysis in the context of the Ratings Navigator for pharmaceutical companies. The IDR of 'B+' reflects Cheplapharm's defensive business profile with resilient and predictable earnings, as well as high operating margins and strong FCF conversion due to the asset-light business model.

We see Chaplapharm's stronger credit profile than the specialist pharmaceutical company IWH UK Finco Ltd (IWH, B/Stable) as warranting a one-notch difference due to the company's higher operating and cash flow margins, in combination with a more conservative financial profile with an FFO adjusted gross leverage of 5.0x against IWH's's 6x. We also regard Chaplapharm as being a stronger credit in comparison with generics producer Nidda BondCo GmbH (Stada, B/Stable), despite its much smaller scale and more concentrated portfolio, which are, however, offset by very strong operating and cash flow profitability and adequate credit metrics. On the contrary, Stada's rating is burdened by an excessive leverage profile with an FFO adjusted gross leverage of around 10x, before gradually declining to 8.0x in the medium term as its FCF reaches mid-to-high-single digits.

Key Assumptions

Fitch's Key Assumptions within our Rating Case for the Issuer

- Revenue growth in excess of 20% in 2019- 2020, driven by prior years' acquisitions, before decelerating to 10% from 2021 on slower M&A. Revenue to remain impacted by TSA-related sales

- EBITDA margin gradually declining to 49% by 2022 from 54% in 2019

- Residual capex of EUR4 million in connection with HQ extension, and EUR1 million for maintenance thereafter

- EUR250 million of IP rights purchased in 2019 followed by EUR100 million a year during 2020-2022 funded by corresponding RCF drawdowns

- Trade working capital outflows of between EUR30 million and EUR45 million a year

- No dividend payments

RECOVERY RATING ESTIMATES

Above- average Recovery Prospects: In our distressed scenario, Cheplapharm would likely be sold or restructured as a going concern rather than liquidated given the asset-light business model. In arriving at a post-restructuring EBITDA, Cheplapharma's pro-forma EBITDA (adjusted for five recently closed acquisitions) of EUR215 million was discounted by 35%, a level at which the company would be in an unsustainable capital structure, triggering some form of debt restructuring. Fitch then applied a distressed enterprise value (EV)/EBITDA multiple of 5.5x, reflecting the underlying value of the company's portfolio of IP rights.

The recovery outcome in such a distressed scenario for the senior secured facilities, comprising the EUR980 million TLB and the EUR310 million RCF is 'BB-(EXP)'/'RR3'/54%.

RATING SENSITIVITIES

An upgrade to 'BB' rating category is not envisaged in the medium term until a more sector critical size with revenue in excess of EUR 1 billion has been reached in combination with a conservative FFO adjusted gross leverage at around 4.0x and FCF remaining strong

Developments That May, Individually or Collectively, Lead to Negative Rating Action

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

- Continuously declining FCF

- FFO adjusted gross leverage sustainably above 6.0x, signaling a more aggressive financial policy

Liquidity and Debt Structure

Ample Liquidity for Acquisitions: Cheplapharm's strong cash generation, which we estimate at EUR100 million in 2019, and increasing to EUR150 million per year by 2022, will contribute towards growing organic liquidity of EUR500 million by 2022. The company also benefits from a sizeable committed RCF of EUR310 million, which further enhances available liquidity headroom. We estimate most of the cash will be applied toward acquisition of IP rights, as opposed to debt reduction.

In our assessment of freely available cash, we deduct EUR10 million of minimum liquidity required for operations in 2018, EUR15 million in 2019-2020 and to EUR20 million in 2021-2022, as the business gains scale.

Summary of Financial Adjustments

RATING ACTIONS

ENTITY/DEBT	RATING	RECOVERY
CHEPLAPHARM Arzneimittel GmbH	LT IDR B+ ● New Rating	
senior secured	LT BB-(EXP) Expected Rating	RR3

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Applicable Criteria

Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)
Corporate Rating Criteria (pub. 19 Feb 2019)

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