MOODY'S
INVESTORS SERVICE

Rating Action: Moody's affirms Cheplapharm's B2 rating, outlook stable

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Paris, January 24, 2020 -- Moody's Investors Service, ("Moody's") has today affirmed Cheplapharm Arzneimittel GmbH (Cheplapharm) B2 corporate family rating (CFR), its B2-PD probability of default rating and its B2 senior secured ratings. Concurrently, Moody's has assigned a B2 senior secured rating to the €500 million of term loan B and the senior secured notes to be issued. The outlook is stable.

"We have affirmed Cheplapharm's ratings because it will use most of the proceeds to refinance existing debts," says Knut Slatten, a Moody's Vice President -- Senior Credit Officer and lead analyst for Cheplapharm. "We believe that the company will maintain a Moody's-adjusted leverage below 5.5x despite its increasing levels of debt and acquisitive financial policy," Mr Slatten added.

RATINGS RATIONALE

Cheplapharm intends to issue €500 million of new debt through a combination of senior secured notes and Term Loan B. Proceeds, along with €29 million of cash, will repay €295 million of drawings under the revolving credit facility (RCF) and a €115 million bridge facility, and prefinance the acquisition of the Sake portfolio, which comprises 10 cardiology and intensive care products, for €110 million.

Although the transaction will also increase reported net debt by €120 million, Cheplapharm will maintain credit ratios commensurate with its current B2 rating. On a Moody's-adjusted basis, Cheplapharm should achieve at constant scope, a gross debt/EBITDA of 5.3x as of year-end 2019, compared with 5.5x in 2018, and generate about €150 million of free cash flow (FCF). Assuming no acquisitions in 2020, apart from the purchase of Sake, which is already agreed, Cheplapharm's Moody's-adjusted gross leverage would fall to about 4.7x in 2020.

Although acquisitions are key to Cheplapharm's strategy, Moody's does not include them in its forecasts because their effect on credit ratios is hard to predict. However, Cheplapharm will likely keep acquiring new products to not only offset the earnings decline of its existing drug portfolio, but also to grow its business.

M&A risk and rising debt constrain Cheplapharm's credit quality. As management intends to grow the business, the acquisition budget has risen significantly. Cheplapharm has made four acquisitions since September 2019: Losec (stomach antacid, €223 million), a portfolio of products previously owned by Sanofi (€67 million), Seroquel (mental disorders, €194 million) and the Sake portfolio (€110 million), for a total of €594 million. Moody's-adjusted debt has increased every year since 2015 because of this aggressive financial policy. Moody's estimates it will be around €1,400 million in 2019, 16 times its 2015 level of €86 million. This has allowed Cheplapharm to grow its revenue to about €480 million from €80 million over that period. Purchasing drugs, where revenues are in decline and earnings growth is dependent on the company generating cost efficiencies could deteriorate Cheplapharm's credit quality as could a failure to integrate newly acquired products.

LIQUIDITY

Cheplapharm's liquidity will be good over the next 12 months. Following the transaction, it will have €16 million of cash and access to a fully undrawn €310 million revolving credit facility (RCF). There will be no significant debt maturities in the coming years because the existing €980 million term loan B3 matures in 2025 and the new debt will mature between 2025 and 2027. Moody's forecasts that Cheplapharm will generate about €150 million of FCF over the next 12 months, as per its definition. However, Moody's thinks that the company will use most of this cash flow, if not all as it has done in the past for acquisitions. As a proportion of absolute debt FCF is forecast to decline to just over 10% in 2019 (2018: 3.8%) from previously higher levels exceeding 15%, although this calculation does not include the full year effect of acquisitions made in the course of 2019.

Cheplapharm RCF is subject to a springing covenant, requiring the company to maintain a net senior secured debt/EBITDA ratio of less than 6.0x if at least 40% of the RCF is drawn. We expect Cheplapharm to maintain good covenant headroom under this covenant.

STRUCTURAL CONSIDERATIONS

The pro forma capital structure of Cheplapharm will comprise mostly senior secured debt located at Cheplapharm Arzneimittel GmbH's level, the main operating entity of the company. This comprises a €980 million term loan B3, a combination of term loan B and notes to be issued for a total of €500 million. It will also have a €310 million RCF. All these debt instruments rank pari passu and have the same security package, which includes a first-priority pledge over Cheplapharm Arzneimittel GmbH's shares as well as pledges over bank accounts and intercompany receivables.

Cheplapharm's Moody's-adjusted debt also includes a shareholder loan for which the company can choose to pay interest in cash and which also offers some loss absorption in a default scenario. The small size of this instrument (around €30 million) does not lead to an uplift of the senior secured instrument rating from the CFR.

Moody's used a family recovery rate of 50%, despite an all-bank debt structure because of the covenant-lite package offered to lenders.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's expectation that Cheplapharm will continue to successfully commercialise its acquired products, as reflected in its limited sales erosion and maintenance of high profit margins, and, as a result, generate continued strong FCF. The current B2 rating provides the company some flexibility to pursue further growth initiatives.

WHAT COULD CHANGE THE RATINGS UP/DOWN

A rating upgrade is unlikely in the near term because of the company's small size and evolving drug portfolio, and its intent to keep growing through acquisitions. A positive rating action would require Cheplapharm to demonstrate its ability and willingness to reduce its Moody's-adjusted (gross) debt/EBITDA below 4.5x on a recurring and sustained basis.

Conversely, Moody's may consider downgrading Cheplapharm's rating if it does not maintain Moody's-adjusted debt/EBITDA pro forma for acquisitions comfortably below 5.5x. The Moody's-adjusted EBITDA margin falling materially below 45% on a sustained basis would also cause a negative rating action. Signs of less effective operations, for instance, an unexpected delay in transferring marketing authorisations or a deterioration in products' profitability after Cheplapharm bought them, may cause a rating downgrade. Lastly, Moody's would lower Cheplapharm's rating if its liquidity deteriorates.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Pharmaceutical Industry published in June 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

COMPANY PROFILE

Headquartered in Greifswald, Germany, Cheplapharm Arzneimittel GmbH (Cheplapharm) is a family-owned company focused on the marketing of off-patent, branded, prescription or niche drugs. Its business model relies on its good relationships with leading pharmaceutical companies such as Roche Holding AG (Roche, Aa3 stable) and AstraZeneca PLC (AstraZeneca, A3 stable), its ability to buy products with sufficient earnings potential at the right price, and the outsourcing of its production and distribution to reliable third parties. Cheplapharm's asset-light operations enable it to generate high cash flow, which it reinvests into new products, offsetting the structural earnings decline in its existing portfolio.

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