

**Rating Action: Moody's changes Cheplapharm's outlook to negative; affirms B2 CFR**

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07 Oct 2020

Paris, October 07, 2020 -- Moody's Investors Service, ("Moody's") has today affirmed Cheplapharm Arzneimittel GmbH's (Cheplapharm) B2 corporate family rating (CFR), its B2-PD probability of default rating, its B2 senior secured ratings and its B2 senior secured bank credit facility rating. At the same time, Moody's changed the outlook to negative from stable.

"We have changed Cheplapharm's outlook to negative because its financial policy is more aggressive than we initially assumed when we affirmed the B2 rating on 6 October," says Vincent Gusdorf, a Moody's Vice President -- Senior Credit Officer and lead analyst for Cheplapharm. "Cheplapharm announced a new transaction shortly after the rating affirmation, bringing the amount of acquisitions signed in 2020 to €1.5 billion" Mr Gusdorf added.

**RATINGS RATIONALE**

Moody's decision to change Cheplapharm's outlook to negative follows the company's announcement on 7 October that it was in advanced negotiations to purchase marketing authorizations and intellectual properties of a product it already sells, for a purchase price of \$400 million. If this transaction materializes, the signing will take place in October or November 2020 and close by the end of the year, although a portion of the purchase price will be paid during the first half of 2021.

As a result, Cheplapharm's Moody's-adjusted debt will rise to about €2.7 billion in 2020 from €1.4 billion in 2019 and €0.9 billion in 2018. Debt will likely rise further in 2021 as Moody's expects that Cheplapharm will continue to make acquisitions and also in quick succession as it has proven to date. Moody's believes that the current pace of debt increase is not commensurate with a B2 rating.

Although Cheplapharm's forecast leverage of 4.6x in 2021 will remain moderate for a B2 rating, it is offset by substantial integration risks. Recent acquisitions will double Cheplapharm's size, which will compel it to substantially increase its headcount. Moreover, the company will need to submit several dozens of marketing authorisation transfers in the coming quarters at a time when it is still integrating acquisitions it made over the past 12 months, notably Losec and Lexotan, which it purchased in Q4 2019, and Sake, which it bought in Q2 2020. There is a risk that future earnings stemming from recently acquired drugs may be lower than Cheplapharm's expectations, even though the overall performances of the acquisitions made so far have been in line with its estimates.

Cheplapharm's liquidity will be adequate over the next 12 months. Although it will have only €1 million of cash at the closing of the acquisitions completed during the third quarter of 2020, it will have access to an €450 million RCF maturing in 2024, which it will partly draw to finance the acquisition announced on 7 October. There will be no significant debt maturities in the coming years because the existing €980 million Term Loan B will mature in 2025 and the secured notes will be due in 2027 and 2028. Moreover, Moody's forecasts that Cheplapharm will generate about €200 million of Moody's-adjusted FCF over the next 12 months, although Moody's expects that it will use most of it for acquisitions.

**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, €500 million of existing senior secured notes and €1 billion of new senior secured notes, as well as a €450 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. Moody's views this security package as relatively weak and therefore considers these debt instruments as unsecured in its loss given default analysis.

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% appropriate for a debt structure comprising bank and bond debts.

#### RATIONALE FOR THE NEGATIVE OUTLOOK

The negative outlook reflects Moody's view that the rapid increase in Cheplapharm's debt and numerous acquisitions in quick succession that will place significant demands on the company's management in order to successfully integrate, shows that its financial policy is more aggressive than the rating agency initially assumed when it affirmed the B2 rating. Cheplapharm will need to materially scale up its operations to successfully integrate the products it has purchased and in order that it maintains a leverage commensurate with its current rating.

#### FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

A rating upgrade is unlikely over the next 12 months in light of the negative outlook. Quantitatively, a positive rating action would require that Cheplapharm maintains its Moody's-adjusted (gross) debt/EBITDA ratio below 4.5x for a prolonged period of time and slows down significantly its M&A activity.

Conversely, Moody's may downgrade Cheplapharm if its debt continues to increase at a similar pace that it has done in the past, or if it is unable to successfully integrate its recent acquisitions, that could be illustrated by an unexpected delay in transferring marketing authorisations or a deterioration in the profitability of new products. Moody's could also lower Cheplapharm's rating if it does not maintain a Moody's-adjusted debt/EBITDA ratio pro forma acquisitions comfortably below 5.5x or if its Moody's-adjusted EBITDA margin declines below 45%. Failing to maintain adequate liquidity, including a concentration in the company's debt maturity profile could also trigger a rating downgrade.

#### Affirmations:

..Issuer: Cheplapharm Arzneimittel GmbH

... Corporate Family Rating, Affirmed B2

... Probability of Default Rating, Affirmed B2-PD

...Senior Secured Bank Credit Facility, Affirmed B2 (LGD3)

...Senior Secured Regular Bond/Debenture, Affirmed B2 (LGD3)

#### Outlook Actions:

..Issuer: Cheplapharm Arzneimittel GmbH

...Outlook, Changed To Negative From Stable

#### COMPANY PROFILE

Headquartered in Greifswald, Germany, Cheplapharm is a family-owned company focused on the marketing of off-patent, branded, prescription and niche drugs. Its business model relies on its good relationships with leading pharmaceutical companies such as Roche Holding AG (Aa3 positive) and AstraZeneca PLC (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 in new products, offsetting the structural earnings decline in its existing portfolio.

#### PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Pharmaceutical Industry published in June 2017 and available at [https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC\\_1062755](https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1062755). Alternatively, please see the Rating Methodologies page on [www.moodys.com](http://www.moodys.com) for a copy of this methodology.

#### REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and

Definitions can be found at: [https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC\\_79004](https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_79004).

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At least one ESG consideration was material to the credit rating action(s) announced and described above.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at [https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC\\_1133569](https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1133569).

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