Research Update:

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

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Rating Action Overview

- Off-patent branded pharmaceutical company Cheplapharm Arzneimittel GmbH (Cheplapharm) intends to issue a €100 million term loan B4 and €400 million of senior secured notes, and will also use €29 million of cash to repay a revolving credit facility (RCF) and bridge loan intended for acquisitions.
- Since its last capital market transaction in June 2019, Cheplapharm has spent €480 million-€485 million on products that we estimate will significantly increase its EBITDA to €340 million-€345 million in 2020 from €260 million-€265 million in 2019.
- We expect the company to integrate these acquisitions, continue to generate strong free operating cash flow (FOCF), and reduce its leverage to comfortably within the 4.0x-5.0x range in 2020, from 5.0x-5.5x in 2019.
- We are affirming our 'B' long-term issuer credit and issue ratings on Cheplapharm and the existing term loan B and assigning our 'B' issue rating to the proposed €100 million term loan B4 and €400 million senior secured notes.
- The stable outlook reflects our view that the company's disciplined acquisition strategy will protect it, to a certain extent, from price erosion, enabling it to limit a natural decline in organic revenue generation. That said, we see limited headroom for additional discretionary debt-funded acquisitions for the next 12 months under the current rating.

Rating Action Rationale

We estimate that Cheplapharm's recent acquisitions and disciplined buying strategy will translate into deleveraging but bring some execution risk. Cheplapharm made three acquisitions during fourth-quarter 2019 and plans to acquire another portfolio of products during first-half 2020. We expect the company to focus on integrating the recent acquisitions and reduce leverage over the rest of 2020, and incorporate only small acquisitions in our base case for this period. Additionally, the documentation for the proposed notes includes an incurrence covenant that prevents Cheplapharm from making acquisitions that would bring its leverage beyond its maximum target. In our base case, we anticipate the company will reduce its leverage and reach S&P Global Ratings-adjusted debt to EBITDA of 4.0x-4.5x in 2020 from our estimate of 5.0x-5.5x in 2019 (including the potential for small acquisitions not signed yet). The latter provides little headroom for operational setbacks and underperformance at the current rating level and we believe it entails some execution risk, due to the substantial size of recent acquisitions, totaling €180 million-€190 million of pro forma EBITDA according to management. We take into account the company's successful track record in integrating newly acquired products without major setbacks, including by successfully transferring marketing authorizations and increasing its headcount to sustain the greater workload.

We anticipate that Cheplapharm will continue to generate substantial 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 contract organization and 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 50%-55% over the next 12-18 months. Given the asset-light business model and our anticipation that the company will continue to manage its working capital requirements well, we project that it will generate FOCF of €190 million-€200 million over the same period. We also assume that the company will utilize internally generated cash for future acquisitions.

We expect Cheplapharm will continue to offset the natural decline in revenue from its existing product portfolio with acquisitions. 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% annually. The business model solely focuses on sourcing assets from outside, which requires sufficient liquidity to finance acquisitions. In our view, Cheplapharm's geographic diversification and positive track record in transferring marketing authorizations make the company a preferred partner for large pharmaceutical companies and give it an advantage in the bidding process. We expect that the company will continue to use its internally generated cash and leverage and relationships with major pharmaceutical companies to acquire new products and offset the natural decline in revenue.

We incorporate a one-notch comparable rating adjustment. We apply a negative comparable rating analysis modifier because of Cheplapharm's business model that relies solely on the acquisition of new drugs to deliver future growth. This could lead to the company overspending on acquisitions and increasing leverage above our base case. The integration of acquisitions will also likely increase the volatility in the company's FOCF generation due to the need to rollout sales and marketing forces and integrate inventories, which could mean volatile working capital requirements.

Outlook

The stable outlook reflects our view that Cheplapharm's operational performance should remain resilient and the company will remain safe from integration setbacks. We anticipate the company will generate a 50%-55% EBITDA margin and €190 million-€200 million of FOCF over the next 12 months. This should help Cheplapharm to build resources to acquire assets and support future growth, while also replenishing lost sales from the existing product portfolio. We expect adjusted debt to EBITDA to remain below 5.0x on average over the next 12-18 months and see limited headroom for further discretionary debt-funded acquisitions over the same period.

Downside scenario

We could lower the rating if we observe a deterioration in Cheplapharm's operational performance such that its ability to generate at least €100 million of FOCF per year is affected and it is unable to reduce leverage to below 5.0x within 12-18 months following the latest acquisition. This could happen if, for example, the company faces operational setbacks in the integration of its recent acquisitions, suffers from unexpected tightening of reimbursement terms, or sees increasing competition that pressures prices. We could also lower the rating if Cheplapharm is unable to replace declining revenue with newly acquired products, purchases products that we consider higher risk, or overpays for products, thus incurring a substantial increase in leverage compared with our base case.

Upside scenario

We could consider an upgrade if the company successfully increases its scale of operations and demonstrates capacity to deleverage to below 4.0x within 12-18 months following its latest acquisitions. This will most likely result from a seamless integration of recent acquisitions and continued execution of the company's disciplined acquisition strategy. Alternatively, we may raise our rating if the company achieves a substantial improvement in scale and diversity to sustain a higher level of leverage. This would mean that the effect of sales declines and the contribution of newly acquired products was a smaller part of the overall portfolio.

Company Description

Cheplapharm is a Germany-based off-patent branded pharmaceutical company. It reported revenue of €290.7 million and S&P Global Ratings-adjusted EBITDA of €187.7 million in 2018.

The company mainly acquires intellectual property rights from pharmaceutical companies after the respective products have run out of patent protection and show 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

In our base case for 2020, we assume:

- Revenue will increase to €620 million-€625 million from about €485 million-€490 million in 2019, supported by acquisitions closed in second-half 2019 and planned additional purchases.
- EBITDA margin will remain at 50%-55% thanks to Cheplapharm's asset-light business model and focus on life-cycle management.
- Annual capex of €10 million-€15 million.
- Annual working capital requirements of €60 million-€65 million.
- Annual acquisitions of €100 million-€200 million.
- No dividends paid.

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

- S&P Global Ratings-adjusted debt to EBITDA of 4.0x-4.5x over the next 12-18 months.
- Funds from operations (FFO) cash interest coverage of 5.5x-6.0x over the next 12-18 months.
- Reported FOCF of €190 million-€200 million in 2020 and 2021.

Our adjusted debt includes the €530 million term loan B1, €300 million term loan B2, €150 million term loan B3, €100 million term loan B4, €400 million senior secured notes, and €30 million of shareholder loans. 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 12 months after the additional acquisitions close. 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, do not include the one-off effect of the refinancing transactions.

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

- €15 million-€20 million of cash available at closing of the refinancing.
- €310 million available under the RCF.
- €260 million-€270 million FFO in 2020

We anticipate that Cheplapharm's principal liquidity uses over the same period will be:

- €60 million-€65 million annual working capital requirements.
- €20 million-€25 million of maximum intrayear working capital requirements.
- €10 million-€15 million of annual capex.
- €100 million-€120 million for planned acquisitions in 2020.

Issue Ratings - Recovery Analysis

Key analytical factors

- The senior secured €980 million term loan B, due 2025, has an issue rating of 'B' and a recovery rating of '3'. Our indicative recovery prospects are in the 50%-70% range (rounded estimate: 50%)

- We assign an issue rating of 'B' and recovery rating of '3' to the proposed senior secured €100 million term loan B4 due 2025 and the proposed €400 senior secured notes due 2027 (rounded estimate: 50%).
- In our hypothetical default scenario, we assume a lack of target products available at accessible prices and increase in price pressure.
- We value Cheplapharm as a going concern given its well-established branded generics position and well-diversified portfolio in geographical terms.

Simulated default assumptions

- Year of default: 2023
- Jurisdiction: Germany

Simplified waterfall

- Emergence EBITDA: About €162 million (capex represents 2% of sales)
- 40% operational adjustment was used to reflect the low capex requirement and the lower leverage compared with peers.
- Multiple: 6.0x
- Gross recovery value: About €973 million
- Net recovery value for waterfall after administrative expenses (5%): About €925 million
- Estimated senior secured debt: About €1,795 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: Aggressive

- Cash flow/Leverage: Aggressive

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: Negative (-1 notch)

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
- General Criteria: Guarantee Criteria, Oct. 21, 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: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- German Pharma Company Cheplapharm Arzneimittel 'B' Ratings Affirmed On Planned Debt Issuance; Outlook Stable, Nov. 6, 2018

Ratings List

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

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.