S&P Global
Ratings

RatingsDirect®

Research Update:

German Pharma Company Cheplapharm Arzneimittel 'B' Ratings Affirmed On Planned Debt Issuance; Outlook Stable

Primary Credit Analyst:
Giuseppe Setzi, London + 44 20 7176 6576; giuseppe.setzi@spglobal.com

Secondary Contact:
Marketa Horkova, London (44) 20-7176-3743; marketa.horkova@spglobal.com

Table Of Contents

Research Update:

German Pharma Company Cheplapharm Arzneimittel 'B' Ratings Affirmed On Planned Debt Issuance; Outlook Stable

Overview

- Germany-based off-patent branded pharmaceuticals company Cheplapharm Arzneimittel GmbH intends raise a €300 million term loan B2 to repay its revolving credit facility (RCF), which it drew on to acquire new products.
- During 2018, Cheplapharm successfully executed its pipeline of acquisitions, spending about €720 million on products that it expects will contribute revenues of about €290 million-€300 million and EBITDA of about €80 million-€90 million in 2019. These figures include two new acquisitions that will be signed in the last quarter of 2018.
- We are affirming our 'B' long-term issuer credit rating on Cheplapharm. We are also affirming our 'B' issue rating on the €530 term loan B1 and have assigned our 'B' issue rating to the proposed €300 million term loan B2.
- The stable outlook reflects our view that the company's geographically diverse portfolio and presence in niche markets will protect it, to a certain extent, from price erosion. This should enable it to limit the natural decline in organic revenue. Coupled with stable profitability, that should let it focus on delevering.

Rating Action

On Nov. 6, 2018, S&P Global Ratings affirmed its 'B' long-term issuer credit rating on Germany-based branded pharmaceuticals company Cheplapharm Arzneimittel GmbH. The outlook is stable.

At the same time, we affirmed our 'B' issue-level rating on the company's €530 million term loan B due 2025. The recovery rating is unchanged at '3', indicating recovery prospects of 50%-70% (rounded estimate: 50%).

We also assigned our 'B' issue-level rating and '3' recovery rating to the proposed €300 million term loan B due 2025. Again, the recovery rating indicates recovery prospects of 50%-70% (rounded estimate: 50%).

Rationale

The affirmation follows Cheplapharm's announcement that it plans to issue a €300 million term loan B2 incremental facility due 2025 to repay €300 million of its revolving credit facility (RCF). It used the RCF to fund the following acquisitions in the second quarter of 2018, which closed at the end of September 2018: Atacand (15% of total sales, estimated pro forma the acquisitions), a legacy product for high blood pressure sourced from AstraZeneca; and Fungizone (6%), an antifungal compound for critical conditions acquired from Bristol-Myers Squibb.

When it closes its transaction, Cheplapharm will again draw part of the RCF to fund two additional acquisitions. The agreements will be signed in the last quarter of 2018 and the transactions will close in the first quarter of 2019.

2018 was a transformational year for Cheplapharm. It spent about €720 million in total on acquisitions throughout the year to broaden its product diversification and therapeutic area. We expect the acquisitions to contribute additional revenues of about €290 million-€300 million and to add about €80 million-€90 million to EBITDA (this including additional acquisitions, not yet signed) by the end of 2019. We consider the company is disciplined in its investment criteria and has not overpaid for the products it acquired. It has focused on smaller, niche products that are less likely to attract competition from other generic players.

Founded in 1998, Cheplapharm reported revenues of about €226 million and EBITDA of about €134 million in 2017. The main products acquired in the first half of this year were Cymevene (8% of total sales), which is used for the treatment and prophylaxis of cytomegalovirus and a portfolio from Roche. This portfolio included Konakion, a treatment for hematology (5%); Lariam, a treatment for malaria, and Inhibace, a cardiology treatment. In the second half of 2018, Cheplapharm acquired Atacand and Fungizone. Cheplapharm also made major acquisitions in 2017, notably Xenical (15% of total sales, estimated pro forma the acquisitions) and Dilatrend (12%). Given the size and the speed of these acquisitions, we expect the company to spend the next 12 months focusing on integrating its recent acquisitions and reducing leverage. We expect it to reach our adjusted debt to EBITDA of about 4.3x-4.5x in 2019-2020. After 2019, we assume that Cheplapharm will make further small bolt-on acquisitions of carefully selected products.

Our adjusted debt includes about €1,016 million of financial debt at year end 2018: the fully utilized term loan B1 (€530 million) and term loan B2 (€300 million), plus about €185 million drawn under the RCF. By year end 2019, we expect the drawings under the RCF to have reduced to €65 million. We don't deduct cash sitting on balance sheet as we view the business risk profile as weak.

One of the main strengths of the company is its asset-light business model, focused on a buy-and-build strategy. Primarily, the company identifies the

right target, and then outsources manufacturing by using a network of contract manufacturing organizations (CMOs) and outsourcing distribution and marketing to external networks. It then implements its experience of managing product life cycles to optimize the process. The company mainly acquires intellectual property (IP) rights from pharmaceutical companies after the respective products have run out of patent protection--when the products have relatively stable revenues, limited competition, and pricing stability. This combination of factors translates into strong profitability and an adjusted EBITDA margin well above 40%. Given the asset-light model, it also means good cash flow conversion.

We project that the company will generate free operating cash flow (FOCF) of about €125 million-€130 million in 2019 and €120 million-€125 million in 2020.

Our assessment of Cheplapharm's business risk profile is constrained primarily by its relatively small size compared with other global generics-focused pharmaceutical companies. In addition, its portfolio primarily comprises niche and older legacy products that have lost patent protection. These products are exposed to price erosion and their revenue naturally declines by 3%-6% a year. The company also lacks in-house research and development (R&D) capabilities. Its business model is solely focused on sourcing assets from outside, which exposes it to a potential lack of suitable assets and requires sufficient liquidity to finance these acquisitions. It chiefly acquires products from larger pharmaceutical companies that consider them to be too small or not attractive enough in terms of returns.

Cheplapharm's focus on small niche drugs means that its products face limited or no competition. They have been on the market and off-patent for some time, and are familiar to prescribers and patients. A high proportion of the company's products are subject to patient co-payments or are fully paid for out of pocket. The company's strategy of avoiding price-driven tenders in markets such as Germany, offers a certain degree of revenue protection, supported by its high degree of geographical diversification. No country represents more than 15% of its revenues. This is important as governments often change reimbursement mechanisms in their efforts to curb costs.

The 2018 acquisitions improved Cheplapharm's product diversification--no single product now accounts for more than 15% of total sales. The biggest-selling drugs--Xenical, Atacand, and Dilatred--together account for about 40% of total sales. Although there is some degree of product concentration, it is mitigated by good geographical diversification.

We apply a negative comparable rating analysis modifier because Cheplapharm is relatively new in the capital markets and its business model 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.

Our base case assumes:
- EBITDA of €140 million-€148 million in 2018, increasing to about €190

million-€200 million in 2019. This includes the acquisitions closed in the second half of 2018 and the planned additional acquisitions.

- Cheplapharm will maintain its profitability metrics, supported by management's focus on life cycle management activities.
- Annual capital expenditure (capex) is likely to be about €5 million-€7 million over the next two years.
- No acquisitions or dividend payments.

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

- Adjusted debt to EBITDA of about 4.3x-4.6x in 2019 and 2020;
- Adjusted fixed charge coverage of about 4.5x-4.6x in 2019-2020; and
- Reported FOCF generation comfortably above €125 million-€130 million in 2019-2020.

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 we do not include the one-off impact of the refinancing transactions.

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

- Cash and cash equivalents of about €10 million post transaction;
- An undrawn revolving credit facility of about €125 million;
- Funds from operations of about €115 million-€120 million over the forecast period; and
- Disposal of assets of about €7 million.

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

- Working capital outflow of about €20 million-€22 million;
- Seasonal working capital outflow of about €20 million; and
- Capex of about €7 million.

Covenants

We understand that there will be a covenant linked to the RCF that will test net senior secured leverage once 40% of the facility is drawn.

Outlook

The stable outlook reflects our view that Cheplapharm's geographically diversified portfolio and presence in niche markets will protect it, to a certain extent, from price erosion, enabling it to generate organic revenue growth of 2%-4% and maintain stable profitability. We expect it to report an EBITDA margin of above 40% over the next 12-18 months. We also expect the company's adjusted debt-to-EBITDA ratio to remain at about 5x and its FOCF to remain above €60 million. This should help Cheplapharm to build resources with which to acquire assets to support future growth and replenish lost sales from the existing products portfolio.

Downside scenario

We could lower the rating if the group's ability to generate at least €50 million-€60 million of FOCF per year diminishes. This could happen if the company suffered from an operational setback, either to the top line or to profitability. Either could be hit by unexpected tightening of reimbursement terms; increasing competition that put pressure on prices; or lower cost synergies. We could also lower the ratings if Cheplapharm proved unable to replace declining revenues with newly acquired products; purchased products that we consider carry higher risk; or overpaid for products, thus incurring a substantial increase in leverage to above 5x.

Upside scenario

We could consider raising the rating if the company demonstrates a sound track record of adjusted debt to EBITDA consistently below 5x, supported by the ability to achieve revenue growth of 2%-3%, while maintaining profitability of above 40% and cash flow generation of above €50 million.

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)

Issue Ratings--Recovery Analysis

Key analytical factors

- The senior secured €530 million term loan B due 2025, has a recovery rating of '3' and an issue rating of 'B'. Our indicative recovery prospects are in the 50%-70% range (rounded estimate: 50%).
- We assigned a recovery rating of '3' and an issue rating of 'B' to the proposed senior secured €300 million term loan B2 due 2025. Our indicative recovery prospects are in the 50%-70% range (rounded estimate: 50%).
- The security package primarily consists of share pledges over material subsidiaries, bank accounts, and intragroup receivables.
- In our hypothetical default scenario, we assume a lack of target products available at accessible prices and increased price pressure.
- We value Cheplapharm as a going concern, given its well-established branded generics position and its well-diversified portfolio in geographical terms.

Simulated default assumptions

- Year of default: 2021
- Jurisdiction: Germany

Simplified waterfall

- Emergence EBITDA: about €85 million (capex represents 1.5% of sales and the cyclicality adjustment is 0%, in line with the industry subsegment)
- 25% operational adjustment was used to reflect the low capex requirement and to reflect the lower leverage compared with peers
- Multiple: 6.0x
- Gross recovery value: about €636 million
- Net recovery value for waterfall after unfunded pension liabilities and admin expenses (5%): about €604 million
- Estimated senior secured debt: about €1,132 million*
- Recovery range: 50%-70% (rounded estimate: 50%)
- Recovery rating: 3

*All debt amounts include six months of prepetition interest.

Related Criteria

- 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: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, 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

- Germany-Based Off-Patent Branded Pharma Company Cheplapharm Arzneimittel GmbH Assigned 'B' Rating; Outlook Stable, Aug. 10, 2018

Ratings List

Ratings Affirmed

Cheplapharm Arzneimittel GmbH	
Issuer Credit Rating	B/Stable/--

Senior Secured	
Local Currency	B
Recovery Rating	3(50%)

New Rating

Cheplapharm Arzneimittel GmbH	
Senior Secured	B
Recovery Rating	3(50%)

Additional Contact:
Industrial Ratings Europe; Corporate_Admin_London@spglobal.com