MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes Cheplapharm's outlook to stable; affirms B2 ratings

20 Dec 2021

Paris, December 20, 2021 -- Moody's Investors Service ("Moody's") has today changed to stable from negative the outlook of Cheplapharm Arzneimittel GmbH's ("Cheplapharm") ratings. At the same time, Moody's has affirmed the company's B2 corporate family rating (CFR), its B2-PD probability of default rating, and the B2 ratings on its guaranteed senior secured notes due 2027 and 2028 and on its senior secured bank credit facilities.

RATINGS RATIONALE

The change of outlook to stable and affirmation of the B2 ratings reflect a more moderate pace of debt-funded acquisitions in the past year and smooth integration to date of the large acquisitions announced in Q4 2020. Moody's also expects that Cheplapharm's credit metrics will meet the requirements for a B2 rating over the next 12 to 18 months, including a Moody's-adjusted gross debt / EBITDA between 4.5x and 5.5x.

In 2021, Cheplapharm performed in line with its guidance and continued to successfully integrate acquisitions closed in late 2020 and early 2021, which included, among others, product portfolios from AstraZeneca plc (A3 negative) and Takeda Pharmaceutical Company Limited (Baa2 positive). While there continue to be risks associated with integrating acquisitions, Moody's expects the company will grow Moody's-adjusted EBITDA to about EUR 650 million in 2021 compared with EUR 370 million in 2020, resulting in Moody's-adjusted gross leverage of around 4.5x by year-end 2021, down from 7.1x at the end of 2020.

Moody's expects Cheplapharm will continue to engage in M&A over the coming years, potentially at a more moderate pace as seen in 2021, and ensure that, if M&A leads to increases in gross leverage, that this will be temporary and that leverage will comfortably return to below 5.5x within 12-18 months.

Cheplapharm's B2 rating continues to reflect its good therapeutic and geographical diversity; a good track record in the timely transfer of marketing authorizations from pharmaceutical companies for products acquired; and the generation of strong cash flow from operations (CFO) and free cash flow (FCF), supported by the company's asset light business model.

The B2 rating remains constrained by the company's structural earnings decline in its existing off-patent product portfolio, which prompts the company to make ongoing product acquisitions to maintain or grow revenues; its relatively short track record of working with well-recognized pharmaceutical companies; an aggressive financial policy, with multiple debt-funded acquisitions undertaken in recent years, which increased its gross debt sharply to EUR 2.8 billion at the end of September 2021 from EUR 0.9 billion at the end of 2018.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects Moody's expectation that Cheplapharm will continue to successfully deliver on the integration of its acquired portfolio of drugs in the next 12 to 18 months and operate with credit ratios commensurate with the B2 rating. Moody's also expects that the company will continue to generate strong CFO to offset rising debt levels.

LIQUIDITY

Cheplapharm's liquidity is adequate. It had EUR 65 million of cash on balance sheet at the end of September 2021 and around EUR 197 million available under its EUR 450 million senior secured revolving credit facility (RCF). There are no significant debt maturities before 2025 when the existing EUR 980 million senior secured Term Loan B will become payable. Moreover, Moody's forecasts that Cheplapharm will generate about EUR 300 million of Moody's-adjusted FCF (before acquisitions) over the next 12 months, which could be used to partly cover future acquisitions.

ESG CONSIDERATIONS

Governance is the most important ESG consideration for Cheplapharm because its credit quality relies on its ability to purchase the right products at the right price and on the integration of acquisitions made in order to support its growth strategy, and because of its tolerance for high leverage, which has resulted in a sharp increase in debt in recent years. Well-established acquisition criteria and management's experience nevertheless mitigate acquisition integration risk. Cheplapharm has also instigated measures to improve its governance through, for instance, the establishment of an external advisory board.

Moody's views social risk as high for pharmaceutical companies, but Cheplapharm is less exposed to this risk than peers. Its product portfolio essentially comprises off-patent drugs that have been on the market for many years, which reduces the risk of product safety issues and of abrupt price declines from regulatory changes.

STRUCTURAL CONSIDERATIONS

The capital structure comprises a EUR 980 million senior secured term loan B, three tranches of EUR 500 million, EUR 575 million and USD 500 million guaranteed senior secured notes, as well as a EUR 450 million senior secured 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 offers some loss absorption in a default scenario. The small size of this instrument (around EUR 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.

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

A positive rating action would require that Cheplapharm maintains its Moody's-adjusted (gross) debt/EBITDA ratio below 4.5x and its cash flow from operations (CFO)/debt ratio above 15% on a sustained basis. An upgrade would also require the company to show commitment to more moderate acquisitions in terms of size and in their financing to ensure that the company limits the impact on credit metrics.

Conversely, Moody's may downgrade 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 CFO/debt ratio declines below 10% for a prolonged period. Failing to maintain adequate liquidity, including a well spread debt maturity profile, could also trigger a rating downgrade.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Pharmaceuticals published in November 2021 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1285013 . Alternatively, 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 and niche drugs. Its business model relies on 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. The group owns a portfolio of more than 125 products that it distributes in over 145 countries. It generated EUR 793 million in revenue and EUR 484 million in EBITDA, on a reported basis, in the nine months ended 30 September 2021. Cheplapharm is 50:50 owned by Sebastian Braun (Co-CEO of the group) and Bianca Juha (Chief Scientific Officer).

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.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at http://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1288235 .

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