FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Cheplapharm at 'B+'; Outlook Stable

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Fitch Ratings - Barcelona - 20 Jan 2023: Fitch Ratings has affirmed Cheplapharm Arzneimittel GmbH's (Cheplapharm) Long-Term Issuer Default Rating (IDR) at 'B+' with a Stable Outlook. Fitch has also affirmed Cheplapharm's senior secured ratings of 'BB-' with a Recovery Rating of 'RR3'.

The IDR balances Cheplapharm's strong operating and cash flow margins with a modest size, moderate leverage and a scalable asset-light business model that relies on acquisitions to offset the modest yet structural decline of its portfolio of off-patent and niche drugs.

The Stable Outlook reflects our expectation that the group will continue pursuing its buy-and-build strategy in a disciplined manner. We expect Cheplapharm to finance acquisitions with internally generated cash flows and additional debt, while maintaining EBITDA leverage at between 4.0x and 5.0x through to 2025.

KEY RATING DRIVERS

Defensive Operations: The rating is underpinned by Cheplapharm's defensive business profile, characterised by predictable revenue and high margins from a diversified portfolio of off-patent drugs, including niche and legacy drugs. The group has a solid record of strong performance, supported by a well-managed intellectual property (IP) portfolio, active product life-cycle management and well-executed acquisitions of drug IP rights.

Mild Organic Decline: Cheplapharm relies on constant acquisitions to grow given the structural low single-digit decline in sales of its portfolio of off-patent drugs. These acquisitions can be funded internally with the group´s strong cash generation. Making acquisitions at disciplined valuation multiples is key and higher interest rates would make debt-financed M&A less attractive.

New Shareholder Loan Credit-Positive: Fitch views the recent EUR500 million shareholder loan provided to the restricted group by its parent Cheplapharm AG as supportive of the rating. This shareholder loan consists of funds raised by Cheplapharm AG from a EUR550 million mandatorily convertible instrument (MCI) maturing in 2029 or when a potential IPO takes place. The MCL was provided by Atlantic Park and GIC, who are expected to own less than 20% of the company after conversion.

Fitch treats the shareholder loan as equity but includes the related interest payments in its projections. Therefore, the new shareholder loan has improved the group's rating headroom, with leverage approaching our positive sensitivities in 2023. We expect Cheplapharm to invest the proceeds in acquiring new drug IP rights.

More Debt-Funded M&A Likely: We expect Cheplapharm to use internally-generated cash, combined with the flexibility under its revolving credit facility (RCF), to prioritise inorganic growth over deleveraging. We estimate that the group would need to invest around 8% of its revenue each year in acquisitions (which we treat as development capex) to offset its organic portfolio decline. This amount can be comfortably funded with internal cash flow generation. Our rating case factors in acquisitions above EUR500 million per year. Larger acquisitions, which would require more funds than committed debt capital, are possible but we treat them as event risk.

Appropriate Leverage, No Deleveraging: Cheplapharm´s leverage has been moderate compared with private-equity (PE)-owned peers', at around 4x-6x gross debt/EBITDA. We expect the group to continue to favour M&A over deleveraging, resulting in stable gross debt/EBITDA over the next four years at 4.0x-4.5x. We assume that the group will not deviate from its disciplined approach to acquisitions, with established acquisition and investment criteria. Acceptance of higher asset valuations, higher-risk product profiles or weaker integration would be negative for the rating.

Financial Policy Key to Rating: Cheplapharm has the ability to deleverage given its strong cash generation, but its strategy has been to prioritise inorganic growth. Last year's decision to postpone the planned IPO due to unfavourable market conditions and to instead issue debt to fund inorganic growth was aggressive, but fully consistent with its financial policy prior to the IPO announcement. We believe that the recent issuance of a EUR550 million MCI instead of debt demonstrate the willingness of the founding

family to continue growing the business while maintaining manageable leverage until a potential IPO takes place.

Supportive Market Fundamentals: Cheplapharm benefits from a strong supply of acquisition targets in the market, as innovative pharma companies look to streamline their product portfolios by divesting off-patent drugs to concentrate on their core therapies and implement their capital-allocation strategies. We regard niche specialist pharmaceutical companies, such as Cheplapharm, as firmly positioned to continue capitalising on this sector trend.

DERIVATION SUMMARY

We rate Cheplapharm using our Ratings Navigator Framework for Pharmaceutical Companies. The IDR reflects Cheplapharm's defensive asset-light business profile with resilient and predictable earnings, as well as high operating margins and strong cash flow generation.

Cheplapharm is rated at the same level as Pharmanovia Bidco Limited (B+/Stable), given smaller-scale but comparable asset-light scalable business model with strong operating and cash flow margins, in combination with moderate debt/EBITDA of 4.0x-5.0x.

Cheplapharm is rated below Grunenthal Pharma GmbH & Co. Kommanditgesellschaft (BB/Stable). Grunenthal's credit profile reflects its more conservative financial policy with leverage of below 3.0x and strong free cash flow (FCF) margins derived from a portfolio of off-patent and innovative drugs and own manufacturing and distribution capabilities, albeit with lower EBITDA margins of around 20%.

We view Cheplapharm's credit profile as stronger than that of the pharmaceutical company ADVANZ PHARMA HoldCo Limited (B/Stable). Although the latter is involved in bringing new niche, specialist and value-added generics to market through co-development, in-licencing, and distribution agreements, it has smaller business scale and lower operating and cash flow margins, warranting a one-notch difference.

We also regard Cheplapharm as stronger than generics producer Nidda BondCo GmbH (B/Negative), despite its much smaller scale and more concentrated portfolio, which is mitigated by wide geographic diversification within each brand. Nidda BondCo's rating is limited by high EBITDA leverage above 7.0x in 2023, and high refinancing risk, with large maturities due in 2024-2025.

KEY ASSUMPTIONS

- Sales growth of 15% in 2023 and 2024 and 8% by 2025, up from 5% in 2022, as acquisitions offset low-single-digit organic declines

- EBITDA margin to gradually moderate to 50% by 2025 from 58% in 2022

- Unspecified acquisitions of EUR600 million a year, except for 2023 when we project M&A of EUR1 billion

- Issuance of EUR500 million shareholder loan in early 2023, treated as equity and resulting in EUR30 million additional interest payment

- Capex at around 1% of sales. Moreover, Fitch treats acquisitions equivalent to 8% of sales as capex, as it views them as necessary to offset the organic portfolio decline

- Trade working-capital outflows of EUR50 million-EUR100 million per year to 2025

- No dividend payments

KEY RECOVERY RATING ASSUMPTIONS

We expect that Cheplapharm in a bankruptcy would most likely be sold or restructured as a going concern (GC) rather than liquidated given its asset-light business model.

We estimate a post-restructuring GC EBITDA at about EUR450 million (previously EUR400 million), which includes contribution from the recently signed but not yet closed drug IP acquisitions scheduled for completion in 1Q23-2Q23. Cheplapharm would be required to address debt service and fund working capital as it takes over inventories following transfer of market authorisation rights, as well as making smaller M&A to sustain its product portfolio to compensate for a structural sales decline.

Fitch continues to apply a distressed enterprise value/EBITDA multiple of 5.5x, reflecting the underlying value of the group's portfolio of IP rights.

After deducting 10% for administrative claims, the allocation of value in the liability waterfall results in a Recovery Rating of 'RR3' for the existing senior secured debt, including its EUR545 million RCF, which we assume will be fully drawn prior to distress. This indicates a 'BB-' instrument rating with a waterfall-generated recovery computation of 63% (56% previously).

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- An upgrade to the 'BB' rating category would require a maturing business risk profile, characterised by sustainable revenue, a more diversified product portfolio, as well as

resilient operating and strong FCF margins that allow the group to finance development M&A and reduce execution risks

- Conservative leverage policy leading to EBITDA leverage at or below 4.0x on a sustained basis

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Unsuccessful management of individual pharmaceutical IP rights leading to material permanent loss of income and EBITDA margins declining towards 40%

- Positive but continuously declining FCF

- More aggressive financial policy leading to EBITDA leverage sustainably above 5.5x

- EBITDA interest coverage below 3x on a sustained basis

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Non-Financial Corporate issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

LIQUIDITY AND DEBT STRUCTURE

Comfortable Liquidity: We view liquidity as comfortable based on Cheplapharm's strong FCF before acquisitions, which we estimate at around EUR400 million a year until 2025. The group benefits from a long-dated term loan B and senior secured note maturities until 2027-2029.

SUMMARY OF FINANCIAL ADJUSTMENTS

Fitch treats the EUR500 million shareholder loan as equity but includes its interest paid in its cash flow projections given the group's intention to pay interest in cash. We also treat EUR15 million of readily available cash as restricted cash.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT	RATING	RECOVERY	PRIOR
CHEPLAPHARM Arzneimittel GmbH	LT IDR B+ Rating Outlook Stable Affirmed		B+ Rating Outlook Stable
senior secured	LT BB- Affirmed	RR3	BB-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Corporates Recovery Ratings and Instrument Ratings Criteria (pub. 09 Apr 2021) (including rating assumption sensitivity)

Corporate Rating Criteria (pub. 28 Oct 2022) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Corporate Monitoring & Forecasting Model (COMFORT Model), v8.1.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

CHEPLAPHARM Arzneimittel GmbH	EU Issued, UK Endorsed

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