FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Cheplapharm at 'B+'/Stable; Rates New Senior Secured Debt 'BB-'/'RR3'

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Fitch Ratings - Frankfurt am Main - 18 Feb 2022: Fitch Ratings has affirmed Cheplapharm Arzneimittel GmbH's (Cheplapharm) Long-Term Issuer Default Rating (IDR) at 'B+' with a Stable Outlook. Fitch has also assigned Cheplapharm's new term loan B (TLB) and revolving credit facility (RCF) senior secured ratings of 'BB-' with Recovery Ratings of 'RR3'. The proceeds are being used to refinance the company's EUR980 million TLB and EUR450 million RCF.

The affirmation of the IDR reflects our view that financial risk remains unchanged, following the latest refinancing, with total debt/EBITDA projected to remain at 5.0x, combined with steady EBITDA margins of around 50% and free cash flow (FCF) margins of 30%.

The Stable Outlook reflects Fitch's expectation that Cheplapharm will maintain the quality and risk profile of its product portfolio by investing all of its internally generated cash flows in new intellectual property (IP) rights, while maintaining its acquisition and financial policies. This will facilitate a stable operating and financial profile, in addition to the removal of near-term liquidity risks resulting from the refinancing transaction.

The ratings for the company's old TLB and RCF were withdrawn as this debt has been redeemed as part of the refinancing.

KEY RATING DRIVERS

Incremental Debt Rating-Neutral: We regard the refinancing as rating-neutral, with the net increase in senior secured debt of EUR500 million being used to fund M&A of around EUR335 million and partially prepay the nearly fully-drawn RCF of around EUR410 million used for recent product additions. The new products were acquired at enterprise value (EV)/EBITDA of less than 5.0x, in line with the company's acquisition record. This contributes to steady, strong EBITDA and FCF margins of 50% and 30%, respectively, which are consistent with the ratings. Combined with a projected total debt/EBITDA 5.0x, this supports the 'B+' IDR.

Aggressive but Consistent Financial Policy: The decision by Cheplapharm to postpone its IPO in response to unfavourable market conditions and issue incremental debt to fund its business growth is aggressive, but fully consistent with its previous financial policy. We expect the company will use the flexibility under its RCF, combined with internally-generated cash, to continue its fast-paced growth, prioritising inorganic growth over deleveraging.

Defensive Operations: The rating is underpinned by Cheplapharm's defensive business profile, characterised by well-executed acquisitions of drug IP rights and active product life-cycle management. We view positively Cheplapharm's predictable, albeit organically declining, revenue from late-stage drugs, enhanced by the addition of new products with comparable economic contribution and risk profile.

Appropriate Leverage, No Deleveraging: We project total debt/EBITDA will remain within our rating sensitivity at about 5.0x. This is driven by the steady quality of Cheplapharm's organic portfolio and disciplined implementation of inorganic growth, based on the company's established acquisition and investment criteria. At the same time, apart from an IPO remaining an event risk, we do not forecast any organic deleveraging as the company continues to favour M&A over deleveraging.

More Debt-Funded M&A Expected: We assume that the company will use FCF, together with any availability under the committed RCF, to fund an estimated at EUR600 million-EUR700million a year of M&A. Larger acquisitions, which would require incremental funds exceeding the total committed debt capital, are also likely and an event risk. Without any commitment to deleveraging, the rating is driven by the company's disciplined approach to acquisitions and a stable organic portfolio. Acceptance of higher asset valuations, higher-risk product profiles or weaker integration would put the rating under pressure.

Supportive Market Fundamentals: Cheplapharm benefits from a continuing strong supply of off-patent drugs to the market as innovative pharma companies look to streamline their product portfolios to concentrate on core therapies and implement their capital-allocation strategies. We regard niche specialist pharmaceutical companies, such as Cheplapharm, as well-positioned to continue capitalising on these positive sector trends.

DERIVATION SUMMARY

We rate Cheplapharm using our Ratings Navigator framework for pharmaceutical companies. The IDR reflects Cheplapharm's defensive business profile with resilient and predictable earnings, as well as high operating margins and strong cash flow generation, due to the company's asset-light business model.

Cheplapharm is rated at the same level as Pharmanovia Bidco Limited (B+/Negative), although Pharmanovia has shown uneven operating performance and increased execution risks around its acquisition strategy and organic portfolio management.

We view Cheplapharm's credit profile as stronger than that of the specialist pharmaceutical company IWH UK Finco Ltd (B/Stable), warranting a one-notch difference. The rating differential reflects the former's higher operating and cash flow margins, combined with a more conservative financial profile as reflected in funds from operations (FFO) gross leverage of 5.0x-5.5x, against IWH's 5.5x-6.0x.

We also regard Cheplapharm as stronger than generics producer Nidda BondCo GmbH (B/Stable), despite its much smaller scale and more concentrated portfolio, which is mitigated by wide geographic diversification within each brand. Nidda BondCo's rating is burdened by high leverage, with a spike in expected FFO gross leverage to 9.0x-10.0x in 2021-2022, following recent operating underperformance amid the pandemic and the impact of debt-funded acquisitions.

KEY ASSUMPTIONS

- Sales growth of around 55% in 2021, decelerating to around 8% by 2024

- EBITDA margin stabilising at 50%-51% in 2022-2024, versus around 57% in 2021

- Capex at around 1% of sales each year to 2024

- Change in trade working-capital outflow of EUR100 million a year through to 2024

- M&A of EUR1.2 billion in 2021-2022 and EUR600 million in 2023-2024 at an EV/sales of 2.5x (EV/EBITDA of 5.0x). M&A will be funded by FCF, drawdowns of the RCF and from planned incremental debt proceeds of EUR500 million in 2022

- No dividend payments through to 2024

KEY RECOVERY RATING ASSUMPTIONS

In a distressed scenario, we expect Cheplapharm 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 EUR400 million (unchanged), which includes contribution from the recently signed but not yet closed drug IP acquisitions scheduled for completion in 1Q22-2Q22. Cheplapharm would also face debt-service and working-capital requirements as it takes over inventories following transfer of market authorisation rights, and makes smaller M&A to sustain its product portfolio to compensate for a natural sales decline.

Fitch applies a distressed EV/EBITDA of 5.5x (unchanged), reflecting the underlying value of the company'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 an upsized RCF of EUR545 million, which we assume will be fully drawn prior to distress, indicating a 'BB-' instrument rating with a waterfall-generated recovery computation (WGRC) of 56% (68% previously given a lower amount of debt before refinancing).

RATING SENSITIVITIES

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

- An upgrade to the 'BB' rating category would require a sustained improvement of Cheplapharm's business scale with sales above EUR1 billion combined with a more diversified product portfolio, resilient operating and strong FCF margins, and reducing execution risks

- A conservative leverage policy with total debt/operating EBITDA at or below 4.0x, or FFO gross leverage at about 4.0x

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

- Failure to complete the refinancing to secure funding for the near-term committed M&A

- 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 with total debt/operating EBITDA sustainably above 5.5x, or FFO gross leverage above 6.0x (net of readily available cash: 5.5x)

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 pre-M&A FCF of EUR350 million-EUR400 million a year until 2024. This, together with the upsized RCF of EUR545 million, will be sufficient to maintain and grow its earnings base as its organic portfolio declines.

Cheplapharm benefits from a long-dated TLB, an RCF's and senior secured notes' maturities beginning in 2028 following the refinancing.

In our assessment of freely available cash, we deduct EUR20 million of minimum liquidity required for operations.

ISSUER PROFILE

Cheplapharm is engaged in the acquisition and management of off-patent branded legacy and niche drugs.

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-	New Rating	RR3	
senior secured	LT	BB-	New Rating	RR3	BB-(EXP)
senior secured	LT	WD	Withdrawn		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. 15 Oct 2021) (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), v7.9.0 (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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