

Research Update:

Germany-Based Pharma Group Cheplapharm Arzneimittel Affirmed At 'B' On Successful Product Acquisitions; Outlook Stable

June 14, 2021

Rating Action Overview

- Off-patent branded pharmaceutical company Cheplapharm Arzneimittel GmbH (Cheplapharm) acquired four product portfolios in fourth-quarter 2020 and one product portfolio in first-quarter 2021.
- We expect Cheplapharm will smoothly integrate these products into its network of contract manufacturers and distributors, likely yielding a significant increase in its scale of operation and improved diversification by product sold and by geographies covered.
- We affirmed our 'B' ratings on Cheplapharm and its existing senior secured debt.
- The stable outlook indicates our expectation that Cheplapharm's disciplined acquisition policy will enable it to achieve EBITDA margins in the 50%-55% range and high levels of free operating cash flow (FOCF) in the next 12 months.

Rating Action Rationale

Cheplapharm is set to continue increasing its scale and diversification of operations thanks to recent product acquisitions. Cheplapharm has grown its EBITDA base in recent years to €343.6 million in 2020 from €187.7 million in 2018. Also over the same period, the company improved its business diversification, with its top three products representing about 25% of 2020 sales, compared to about 49% in 2018. Furthermore, no country represented more than 13% of 2020 sales. We anticipate that the recent acquisitions will further increase Cheplapharm's scale of operation and that its EBITDA will reach €570 million-€600 million in 2021. Our forecast also considers potential new product acquisitions throughout 2021. Moreover, we anticipate that the recent series of acquisition could potentially further improve Cheplapharm's product and geographical diversification in the next 12 months.

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Cheplapharm has successfully managed the execution risks of its acquisition strategy, and we expect smooth product integrations. The integration of new assets carries execution risks associated with the need for the timely transfer of marketing authorizations (MA), the seamless integration of products in Cheplapharm's network of contract manufacturing organization, and the realization of targeted gross margins from new products. That said, Cheplapharm has proactively increased its staff to 428 in March 2021 from 320 in December 2019; this should help it manage the transfer of MAs for the new products in each country. We consider Cheplapharm's successful track record of transferring MAs and integrating acquired products into its network of manufacturing partners within the timeframe it has agreed with the seller. Moreover, Cheplapharm has historically been disciplined regarding the price it pays for new products. We also note the group has been careful to acquire branded products that do not require marketing efforts to realize the expected gross profit. We expect Cheplapharm to continue applying its disciplined acquisition policy and therefore manage execution risks.

We forecast that Cheplapharm will continue to generate substantial FOCF thanks to its high 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. 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%-53% over the next 12 months. Given the asset-light business model and our expectation that the company will continue to effectively manage its working capital requirements, we project that it will generate annual FOCF of €220 million-€250 million over the coming year. We also assume that the company will utilize internally generated cash for future acquisitions.

Cheplapharm is likely to report an average debt leverage ratio of close to 5.0x over 2021-2022. This is thanks to the company's business model and financial policy. 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% a year. The business model solely focuses on sourcing assets from outside, financed by internally generated liquidity, available revolving credit facility (RCF), and new debt. In our view, Cheplapharm has good relationship with large pharmaceutical companies, which gives it an advantage in the bidding process. We expect that the company will continue to use a combination of internally generated cash and debt to allocate about €500 million annually for new products acquisitions and offset the natural decline in revenue. Our forecasts also consider the risk that credit metrics could temporarily deviate from this level depending on the timing of debt-financed acquisitions.

Outlook

The stable outlook indicates that Cheplapharm's operating performance is likely to remain resilient. According to our forecasts, the company will see an EBITDA margin of about 50%-53% and debt leverage ratio of close to 5.0x or below in the next 12 months, reflecting a seamless integration of new assets. We consider the risk that the company's debt leverage ratio could temporarily deviate from this level, depending on the timing of acquisitions. We forecast that Cheplapharm will generate EBITDA of about €570 million-€600 million and FOCF of about €220

million-€250 million in 2021. Given the large amount of debt in its capital structure, we expect Cheplapharm to continue generating substantial annual FOCF under the current rating.

Downside scenario

We could lower the rating if we observe a deterioration in Cheplapharm's operating performance. This would include annual FOCF of below €200 million or it's a debt leverage ratio staying above 5.0x within the 12-18 months after the latest acquisition. This would most likely occur if Cheplapharm acquired a portfolio of medicine at high EBITDA multiples, or if it faces setbacks in integrating the new assets.

Upside scenario

We could consider an upgrade if the company integrates seamlessly newly acquired products and continues to improve its scale and product diversity. This would most likely occur if the company continued to apply a disciplined acquisition strategy. Under this scenario, we would expect Cheplapharm to sustain strong profitability and cash flow conversion, in line with historical trends, while maintaining its debt to EBITDA close to 5.0x or below.

Our upside scenario comprises the following triggers:

Adjusted EBITDA margin comfortably in the 50%-55% range;

FOCF sustainably exceeding €250 million; and

Adjusted debt-to-EBITDA ratio sustainably remaining below 5.0x.

Company Description

Cheplapharm is a Germany-based off-patent branded pharmaceutical company. It reported revenue of €678.8 million and S&P Global Ratings-adjusted EBITDA of €343.6 million in 2020.

The company mainly acquires intellectual property rights from pharmaceutical companies after the respective products have run out of patent protection, but while they still demonstrate 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

Assumptions

- Revenue growth of about 60%-65% in 2021 to €1,090 million-€1,120 million, and to grow annually by about 7%-10% thereafter. Revenue growth will likely stem from the integration of recent and upcoming acquisitions.
- Adjusted EBITDA margin of 50%-53% thanks to Cheplapharm's asset-light business model and focus on life-cycle management.

- Working capital requirement of about €160 million-€180 million in 2021, reflecting the integration of inventories for acquired products.
- Limited annual capex requirement for about €5 million-€10 million.
- FOCF of about €220 million-€250 million.
- About €500 million annually for product acquisitions.
- No dividend paid, in line with Cheplapharm's financial policy.

Key metrics

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

- Adjusted debt to EBITDA of about 5.0x or below in the next 12-18 months and in the absence of large debt-funded acquisition; and
- Funds from operations (FFO) cash interest coverage of about 5.0x in the next 12-18 months.

In our debt calculation, we include €980 million of term loan B4, €1,075 million senior secured notes, \$500 million senior secured notes, any amount drawn under the €450 million of RCF, €30 million of shareholder loan and our expectation of about €120 million-€140 million of available cash as of December 2021.

S&P Global Ratings believes there remains high, albeit moderating, uncertainty about the evolution of the coronavirus pandemic and its economic effects. Vaccine production is ramping up and rollouts are gathering pace around the world. Widespread immunization, which will help pave the way for a return to more normal levels of social and economic activity, looks to be achievable by most developed economies by the end of the third quarter. However, some emerging markets may only be able to achieve widespread immunization by year-end or later. We use these assumptions about vaccine timing in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Liquidity

We view Cheplapharm's liquidity as adequate, indicating that sources of cash will cover uses by at least 1.2x over the next 12 months. 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 therefore do not include the one-off effect of the debt-funded transaction.

We anticipate that Cheplapharm's liquidity sources over the 12 months from April 1, 2021, will be:

- €53.8 million of available cash;
- €211 million of available RCF; and
- €420 million-€440 million cash FFO.

We anticipate the following liquidity uses for the same period:

- €160 million-€180 million of working capital to integrate inventories for acquired products; and
- €5 million-€10 million of annual capex.

Covenants

The senior facility agreement includes a springing covenant tested quarterly when 40% or more of the RCF is drawn. Under this covenant, the net senior secured leverage ratio is limited to 6.0x.

Moreover, the debt documentation includes an incurrence covenant that prevents Cheplapharm from making acquisitions that would bring its net senior secured leverage ratio above 4.25x, after considering any pro forma effects and anticipated synergies from acquired products.

In our base case, we expect Cheplapharm to maintain adequate headroom under its financial covenants.

Issue Ratings - Recovery Analysis

Key analytical factors

- The senior secured €980 million term loan B4 due 2025, the €500 million senior secured notes due 2027, the €575 million senior secured notes due 2028 and the \$500 million senior secured notes due 2028 have an issue rating of 'B' and a recovery rating of '3'. This indicates recovery prospects in the 50%-70% range (rounded estimate: 50%).
- In our hypothetical default scenario, we assume a lack of target product availability at accessible price and an increase in price pressure.
- We value Cheplapharm as a going concern given its well established branded generics position and well diversified portfolio in geographic terms.

Simulated default assumptions

- Year of default: 2024
- Jurisdiction: Germany

Simplified waterfall

- Emergence EBITDA: €256 million
- --Capex represents 1% of sales
- --0% cyclical adjustment
- --60% operational adjustment was used to reflect the low capex requirement, high profitability and cash-flow conversion
- Multiple: 6.5x
- Gross recovery value: €1664 million
- Net recovery value for recovery after admin expenses (5%): €1580 million
- Estimated senior secured debt: about €2940 million*
- Recovery range: 50%-70%

- Recovery rating: 3

*All debt amounts include six months prepetition interest

Ratings Score Snapshot

Issuer Credit Rating: B/Stable/--

Business risk: Fair

- Country risk: Intermediate
- Industry risk: Low
- Competitive position: Fair

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable ratings analysis: Neutral (no impact)

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
- 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
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Country Risk Assessment Methodology And Assumptions, 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: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Ratings Affirmed

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.

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