Ache Laboratorios Farmaceuticos S.A. (/gws/en/esp/issr/90982911)

FitchRatings

Fitch Affirms Ache's IDR at 'BB+'; Outlook Negative

Fitch Ratings-Chicago-31 January 2018: Fitch Ratings has affirmed Ache Laboratorios Farmaceuticos S.A.'s (Ache) Long-Term Foreign Currency Issuer Default Rating (FC IDR) at 'BB+', Long-Term Local Currency IDR (LC IDR) at 'BBB and its National Scale Rating at 'AAA(bra)'. The Rating Outlook is Negative for the FC IDR and Stable for the LC IDR and National Scale Rating. The Negative Rating Outlook for the Foreign Currency rating mirrors Fitch's Negative Outlook for the Brazilian sovereign (FC IDR 'BB'). A full list of ratings follows at the end of this release.

Ache's investment grade LC IDR reflects the defensive nature of the pharmaceutical industry, which translates into a low level of cash flow volatility during a five year rating period, and its strong business position in the Brazilian pharmaceutical market with a leadership position in the prescription drug segment. Ache has higher margins than its Brazilian peers due to its mix portfolio, focused on prescription segment, strong brands that get pricing premiums and its market leading size, which helps fixed cost dilution. The company's position is viewed to be sustainable due to its large sales team that gives it a key competitive advantage in terms of outreach to the medical community and brand awareness.

Ache financial profile resembles that of global peers rated in the 'A' category because of its low debt levels relative to cash flow, high cash balance and strong free cash flow generation before dividends. The ratings incorporate Fitch's expectation that Ache's will remain committed to an unleveraged capital structure, while managing its growth with cash flow supporting organic growth and small acquisitions. Fitch expects net leverage ratios to remain below 0.8x in the next four years. Ache has a track record of shareholder-friendly dividends policy, but Fitch considers that the company has flexibility to adjust payouts if necessary to avoid deterioration of its credit metrics due to the fact that ownership of the company is concentrated in three families.

Ache's LC IDR has been constrained at 'BBB' by its lack of geographic diversification, as the company generates essentially all of its cash flow in Brazil, a country with high operating risk. The company also does not have the size or global market positions of peers rated in the 'A' category such as Pfizer, Merck, AstraZeneca and Bristol-Myers Squibb. Ache's 'BB+' FC IDR is capped by Brazil's Country Ceiling (BB+), as the company's operations are essentially in Brazil and it does not have substantial assets or cash held abroad to help mitigate transfer and convertibility risk.

KEY RATING DRIVERS

Solid Business Profile: Ache has a solid and recognized brand in the Brazilian pharmaceutical industry. Its diversified product portfolio, leadership in the prescription drugs segment, and presence in the fast-growing over-the-counter (OTC), generics and dermo-cosmetics segments support its sound business profile. Ache is the fourth-largest laboratory in Brazil and has one of the largest sales forces in the domestic market, which provides a key competitive advantage compared with local and international peers. This allows an extensive outreach to the medical community, which is crucial for having its products receive prescriptions.

Low Product-Portfolio Risk: Ache's operating cash flow is not exposed to license renewals or patent expirations. Similar to other emerging-markets pharmaceutical companies, Ache has a narrower research and development (R&D) product pipeline than its multinational competitors and has a weaker portfolio of patented products. Positively, the company's exposure to licensing agreements is low, representing less than 7% of revenues from these products. Ache has consistently been increasing its efforts to innovate and renovate its product portfolio by investing about 2.5% of its revenues in R&D. During 2017, Fitch expects products launches to rise to around 27% of revenues from 16% in 2012.

Increasing Competition: Over the last few years, competition has increased with the local pharmaceutical players consolidating brands and expanding their product reach across segments and therapeutic classes. Also, some competitors started to present their market position under group basis instead of single entities. As a result, Ache's lost two market positions in the total Brazilian pharmaceutical market becoming the fourth largest player in terms of net revenues. In its key segment, prescription segment, Ache remains the leader with a 6.6% market-share. Fitch expects Ache's margins to be under pressure at the 28%-30% range but it remains adequate in comparison with average of the industry. Increased competition has led to higher product development and marketing expenses. Fitch believes that Ache's Brazilian operating expertise and strong distribution system will is key factor to help to mitigate this increasing competition.

CFFO to Remain Sound: Fitch expects Ache's cash flow from operations (CFFO) to remain robust despite increased competition. Ache's net revenue and EBITDA during the LTM ended Sept. 30, 2017 were BRL2.8 billion and BRL835 million, respectively, with EBITDA margins at 29.4%. These figures compare with net revenues of BRL2.7 billion and EBITDA of

BRL820 million in 2016, with EBITDA margin of 30.5%. Fitch forecasts the company's EBTIDA margin will move to around 28%-30%, a decline from the 32%-35% over the last four years. Funds from operations (FFO) and CFFO remained strong, at BRL723 million and BRL623 million, respectively, during the same period.

Dividends and Capex to Pressure FCF: Ache has a track record of maintaining an aggressive shareholder-friendly policy, which has led to negative free cash flows (FCF) since 2012. Between 2012 and 2016, Ache generated an average negative FCF of BRL55 million. Dividend distributions averaged BRL377 million per year in the period, or over 90% dividends payouts. Fitch expects that in a more challenging scenario, the company would pursue a more conservative dividend policy in order to increase its financial flexibility and sustain its strong capital structure. This assumption takes into consideration Ache's plan to expand its capacity by 50% with a new production facility in Permanbuco, with estimated costs of BRL500 million. During the LTM ended September 2017, Ache generated FCF of BRL88 million, after BRL78 million capex and BRL457 million of dividend pay-outs (around 85% of net income).

Unleveraged Capital Structure: Ache has historically maintained low leverage ratios, and its credit measures continue to be quite strong. Fitch's projections indicate a net debt/EBITDA ratio to remain below 0.8x in the next four years. Fitch's base case scenario incorporates the new capex for the new facility and around 75% of dividends payout. Under this scenario, Fitch also considers an exercise of potential cash disbursement with new partnerships/small acquisitions in total amount of BRL150 million for the next three years. In the past five years, the company's average leverage, as measured by the FFO adjusted leverage ratio, was 0.4x, while its net debt/EBITDA ratio was negative at 0.2x.

DERIVATION SUMMARY

Ache's LC IDR and National Scale 'BBB'/'AAA(bra)' ratings reflect the defensive nature of the pharmaceutical industry, its leadership position in the prescription drug segment and low product portfolio risk with no exposure to patent or licenses. Ache's lack of geographic diversification, lower business scale, relatively narrower research portfolio and credit access/financial flexibility compared to top pharmaceutical companies currently constrains its 'BBB' local currency ratings. Ache is well positioned in terms of profitability and leverage compared. Most of top global pharmaceutical issuers are rated 'A'/'AA' by Fitch, with average EBITDA margin of 31% and average net leverage of 1.5x.

In comparison with others Brazilian issuers in Fitch's rated universe, Ache's business resilience to economic cycles, strong CFFO generation, financial flexibility as well as its unleveraged capital structure stands-out within the peers. Within Fitch's 'BBB' portfolio average net leverage, measured by net debt/EBITDA, is 1.2x. Ache's capital structure has consistently been stronger. During the next four years, Fitch projects the company's net leverage will remain below 0.8x. Ache's operations concentrated in Brazil and lack of operating/financial assets abroad cap its ratings in the Brazilian Country Ceiling of 'BB+'.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
--Revenue growth in the mid-single digits from 2018 to 2020;
--Innovation to continue to represent around 25% of revenues (R&D expenses of around 3% of revenue);
--EBITDA margin in the range of 28%-30% due to increasing SG&A related to diversification of the portfolio;
--Annual average capex of BRL340 million for 2018-2019 and BRL140 million during 2020, which includes the construction of the new plant in Pernambuco;
--Maintenance of the high dividend pay-outs at around 75% of net income;
--Disbursement of BRL150 million in small acquisitions/partnerships in the next three years.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
For the Foreign Currency IDR, positive rating actions are limited by Brazil's country ceiling of 'BB+', while for the Local Currency IDR of 'BBB', an upgrade is unlikely in the medium term.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
Ache's credit ratios are very strong at the current rating level, but unexpected events that move the company's net leverage beyond 2.0x could result in negative rating action for the Local Currency IDR or National Scale Rating. Significant market-share or brand deterioration could also trigger a downgrade. A further negative rating action on Brazil's sovereign ratings and country ceiling could also result in negative rating action for the company's foreign currency IDR.

LIQUIDITY

Robust Liquidity: Ache's has historically held a robust liquidity position. As of Sept. 30, 2017, Ache's cash balances covered its total debt by 1.1x. As of the same date, the company reported BRL221 million of cash and marketable securities and total adjusted debt of BRL194 million, of which BRL45 million was short-term. About 65% of Ache's debt is with the Brazilian Development Bank (BNDES).

FULL LIST OF RATING ACTIONS

Fitch has affirmed the following ratings:

Ache Laboratorios Farmaceuticos S.A.'s (Ache):
--Foreign Currency Issuer Default Rating (IDR) at 'BB+'; Outlook Negative;
--Local currency IDR at 'BBB'; Outlook Stable;
--National Scale rating at 'AAA(bra)'; Outlook Stable.

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Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017) (https://www.fitchratings.com/site/re/901296)
National Scale Ratings Criteria (pub. 07 Mar 2017) (https://www.fitchratings.com/site/re/895106)

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