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Ratings

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Research Update:

Ache Laboratorios Farmaceuticos S.A. 'BB+' Global Scale Ratings Affirmed; Outlook Still Stable

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Overview

- We expect Brazil-based pharmaceutical company Ache to continue increasing its cash flow generation due to its solid market position, with a strong pipeline of new drug launches.
- We're affirming our 'BB+' global scale and 'brAAA' Brazilian national scale corporate credit ratings on Ache.
- The stable outlook reflects our expectation that Ache will continue posting solid revenue growth and low leverage, with debt to EBITDA consistently below 0.5x.

Rating Action

On Jan. 29, 2018, S&P Global Ratings affirmed its 'BB+' global scale and 'brAAA' Brazilian national scale corporate credit ratings on Ache Laboratorios Farmaceuticos S.A. (Ache). The outlook remains stable.

Rationale

The ratings affirmation reflects our view that Ache will continue delivering strong cash flow generation as result of its strong pipeline of new drug launches and satisfactory regulatory approval rates (close to 100%), coupled with consistent portfolio maturation. At the same time, we expect the company to maintain its solid market position in the Brazilian pharmaceutical market along with very low leverage despite a debt increase to finance the construction of a new industrial plant. On the other hand, Ache has a much smaller scale and less geographic and manufacturing facility diversification compared to its global peers.

The company recently started the construction of a new industrial plant with a distribution center in the Northeast region of Brazil. After the works are completed and operating, Ache won't rely on third parties to produce solid drugs any longer, allowing for stronger profitability. We believe the company will fund the capital expenditures (capex) of about R$500 million to build the plant with long-term debt. Although this will represent a meaningful gross debt increase, we expect the company to maintain low leverage, with debt to EBITDA below 0.5x (compared to a net cash position in the past) due to Ache's continued revenue and cash flow generation growth. We believe the company will continue distributing excess cash as dividends in the next few years, leading to negative discretionary cash flow, but that it will nevertheless maintain comfortable leverage in line with its minimal financial risk profile.

Our base-case scenario assumes:

- Brazil's GDP growth of 2.2% in 2018 and 2.4% in 2019.
- Inflation rate of 3.6% in 2018 and 4.0% in 2019.
- Brazilian basic interest rate of 7.0% in 2018 and 7.25% in 2019.
- Average exchange rate of R$3.33 per $1.00 in 2018 and R$3.38 per $1.00 in 2019.
- Annual volume growth of 5.0%-9.0% from new drugs launches and portfolio maturation. We expect prescription and generic drugs to represent the largest portion of launches.
- Prescription drug price increases will be, on average, 4.2% in 2018 and 4.4% in 2019, assuming 60% inflation (historical average) plus a 2% premium to factor in new drug launches, which usually involve higher prices. For the remaining categories (OTC, dermocosmetics, generics), we assume price adjustments aligned with inflation.
- The combination of volumes growth and price increases drive our forecasted revenues growth of around 10.0% in 2018 and 2019.
- EBITDA margins remain relatively stable in 2018 because of higher foreign exchange and the maintenance of high research and development (R&D) to support the new product pipeline, countered by lower inflation and its increasing scale. In 2019, we expect a higher EBITDA margin, reflecting strict cost controls and a more efficient management structure.
- Annual capex of R$340 million in 2018 and 2019, mainly to build the new plant and also dedicated to operations maintenance.
- Dividend payout between 80% and 100% of the previous year's net income.
- Debt increase of R$500 million (we assume that half of it would be disbursed in 2018 and the remainder in 2019) to fund the construction of the new plant.

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

- EBITDA margin around 30% in 2018 and close to 33% in 2019, compared to 30% in 2017;
- Debt to EBITDA between 0.0x and 0.5x in 2018 and 2019, compared to zero in 2017;
- Funds from operations (FFO) to debt consistently above 150%; and
- Negative discretionary cash flow due to sizable dividend payments.

Ratings above the sovereign

The global scale rating on Ache is two notches above Brazil's sovereign foreign currency rating (BB-/Stable/B) because, in our view, there's a considerable likelihood that Ache wouldn't default in a hypothetical scenario of sovereign default due to its comfortable liquidity position, with very few short-term debt maturities and the flexibility to reduce dividends and capex.

We consider pharmaceutical entities to be moderately sensitive to Brazil's economy, given the resilience of the industry. This resilience allows us to rate Ache above the sovereign, but we cap the rating at the country's 'BB+' transfer and convertibility (T&C) assessment due to the concentration of its

business in Brazil.

Under a simulated sovereign default scenario, we would expect to see:

- GDP contraction of 10%, doubling foreign exchange and basic interest rates (compared to our base-case scenario), and an inflation rate of 12.5%.
- GDP decline and high unemployment would reduce revenues by about 10% due to lower volumes and no price increases.
- Inflation and a doubled foreign exchange rate would increase costs and expenses, leading to an EBITDA decline close to 25%, relative to our base case.
- Doubling of basic interest rates would increase Ache's interest expenses on its floating-rate debt.
- Haircut of 70% off the company's short-term investments and of 10% off bank deposits.
- Under weaker cash flow generation, we assume the company would reduce capex to maintenance levels of about R$70 million and would not distribute dividends.
- We assume that in this scenario, Ache would postpone the construction of the new plant, and therefore the BNDES construction loan would not be disbursed.
- Even under this hypothetical scenario, the company's cash sources would be sufficient to cover its short-term needs, given its smooth debt amortization profile and its flexibility to reduce dividends and capex.

Liquidity

We assess Ache's liquidity as adequate. While we expect the company to maintain high dividend payouts due to strong cash flow generation, it would have the flexibility to reduce this cash outflow under a stress scenario, resulting in sources over uses of cash above 1.5x in the next 12 months. We don't expect the company to reduce dividend payments such that sources over uses of cash would be above 1.5x in a consistent manner, which underpins our view of its adequate liquidity. In addition, because the company is not a frequent issuer in local and external credit markets, we wouldn't have sufficient evidence for a stronger liquidity score.

We expect net sources to remain positive even if EBITDA were to decline by 15% from our forecast. The company will likely maintain significant headroom on its covenants of net debt to EBITDA below 3.0x and total liabilities to total assets below 75%.

Principal Liquidity Sources:

- Cash position of R$221.4 million as of Sept. 30, 2017;
- Projected cash funds from operations (FFO) of about R$715 million in the next 12 months from Sept. 30, 2017; and
- New debt with BNDES amounting to R$252.1 million to be disbursed in the next 12 months to fund the new plant construction.

Principal Liquidity Uses:

- Short-term debt maturities of R$45.5 million as of Sept. 30, 2017;

- Projected working capital needs of around R$100 million in the next 12 months;
- Capex of about R$275 million in the next 12 months; and
- Forecasted dividend distribution of about R$160 million in 2018 (reduced to 25%, in line with the minimum payments of its Brazilian peers).

Outlook

The stable outlook reflects our expectation that Ache will continue to show solid revenue growth due to new drug launches. Hence we believe that the company will continue to generate increasing cash flow, allowing it to maintain its conservative leverage levels of debt to EBITDA consistently below 0.5x, even with the construction of the new plant that will be financed with debt.

Downside scenario

In our view, a downgrade is unlikely in the next 12 months because the sovereign outlook is stable, and we expect the company to maintain stable operating and financial performance.

We would lower the ratings if Brazil's T&C assessment is revised downward to 'BB' due to a sovereign downgrade. Assuming Brazil's T&C assessment remains at 'BB+', we would only downgrade Ache if we saw significant deterioration in its credit metrics, with debt to EBITDA consistently above 3x and/or weakened liquidity. Nevertheless, we could lower Ache's stand-alone credit profile from 'bbb-' to 'bb+' if its debt to EBITDA were above 2x and/or liquidity weakened as result of significant debt increase to fund potential acquisitions or more aggressive dividend distributions. However, we don't foresee these scenarios in the short to medium term because of the management's very prudent approach to debt. Additionally, in the event of weakened liquidity, we would reassess the extent to which the company can be rated above the sovereign.

Upside scenario

We could raise the ratings in the next 12-18 months if we were to raise Brazil's T&C assessment. We see improvement in Ache's SACP as unlikely in that period because we don't expect meaningful improvement in company's scale or geographic and product diversification, all of which will continue to be much weaker than market participants globally.

Ratings Score Snapshot

Corporate Credit Ratings:
- Global Scale: BB+/Stable/--
- National Scale: brAAA/Stable/--

Business risk: Fair
- Country risk: Moderately High

- Industry risk: Low
- Competitive position: Fair

Financial risk: Minimal
- Cash flow/Leverage: Minimal

Anchor: 'bbb-'

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

Stand-Alone Credit Profile:'bbb-'

Rating, post Ratings Above Sovereign Analysis: 'BB+'

Related Criteria

- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables, Aug. 14, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: National And Regional Scale Credit Ratings, Sept. 22, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Pharmaceutical Industry, April 8, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

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Ratings Affirmed

Ache Laboratorios Farmaceuticos S.A.	
Corporate Credit Rating	
Global Scale	BB+/Stable/--
Brazil National Scale	brAAA/Stable/--

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. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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