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

Fitch Ratings - Rio de Janeiro - 04 Feb 2021: Fitch Ratings has affirmed Ache Laboratorios Farmaceuticos S.A.'s Long-Term (LT) Foreign Currency (FC) Issuer Default Rating (IDR) at 'BB', LT Local Currency (LC) IDR at 'BBB' and National Scale Rating at 'AAA(bra)'. The Outlook is Negative for the FC and LC IDRs and Stable for the National Scale Rating.

Ache's investment-grade LC IDR reflects the defensive nature of the pharmaceutical industry, which translates into a low level of cash flow volatility, and its strong business position in the Brazilian pharmaceutical market, with leadership in the prescription segment.

Ache has higher margins than Brazilian peers due to a portfolio mix focused on the prescription segment, strong and established brands with pricing premiums, and its market-leading size, which helps dilute fixed costs. Fitch views Ache's market position as sustainable, reinforced by a large sales team, which gives it a key competitive advantage in reaching out to the medical community and building brand awareness.

The ratings incorporate Fitch's expectation that Ache will remain committed to an unleveraged capital structure, while managing its organic growth plans or small acquisitions with its resilient FCF generation before dividends and access to funding lines at competitive costs. Fitch expects net leverage ratios below 0.6x in the next four years. Ache has had a shareholder-friendly dividends policy but Fitch believes the company has flexibility to adjust payouts if necessary to avoid deterioration of its credit metrics, as its ownership is concentrated in three families.

Ache's LC IDR is constrained at 'BBB' due to its lack of geographic diversification. The company generates essentially all of its cash flow in Brazil. Ache also has limited scale and market position compared with its global peers rated in the 'A' category, such as Pfizer Inc. (A/Negative), Merck & Co., Inc. (A+/Stable) and Bristol-Myers Squibb Co. (A-/Negative). Ache's FC IDR is capped by Brazil's Country Ceiling of 'BB', as its operations are essentially in Brazil and it does not have substantial assets or cash held abroad to mitigate transfer and convertibility risk.

Ache's operating performance has remained mostly robust during the pandemic, demonstrating defensive qualities and flexible portfolio mix. We observed some demand imbalances linked to the pandemic, with increasing demand for critical drugs at the beginning of the lockdown, followed by weaker demand for elective treatments, which gradually recovered as lockdown measures eased in 2H20.

Key Rating Drivers

Positive Industry Fundamentals: In Fitch's view, the pharmaceutical industry has positive long-term fundamentals, in light of the aging world population and increasing access to health systems. Historically, the sector has consistently outperformed the growth of the economy. In the last five years, the Brazilian pharmaceutical market has reported an average annual increase of 8%, above the rate of Brazilian GDP growth, indicating resilient demand even in adverse macroeconomic conditions.

The higher incidence of chronic diseases and the need to invest in new treatments will continue to boost consumption of medicines in the future. Innovation in the oncology segment should contribute to growing cash flow in the medium term. Longer term, increased competition and the maturing of patents may generate some price pressures, as it occurs with generic drugs. Ache's ability to maintain a sustainable volume of product launches each year and to increase the share of innovations in its portfolio will be key factors in preserving its competitive position.

Solid Business Profile: Ache has a solid and recognized brand in the Brazilian pharmaceutical industry. The company's diversified product portfolio, leadership in the prescription drug segment and presence in the fast-growing over-the-counter (OTC), generics and dermo cosmetics segments support its sound business profile.

Ache is the fifth-largest pharmaceutical company in Brazil and has one of the largest sales forces in the domestic market. This gives the company a key competitive advantage over local and international peers, as it allows for extensive outreach to the medical community; a crucial demand driver for prescription drugs.

Low Product Portfolio Risk: Ache's operating cash flow is not significantly exposed to license renewals or patent expirations. Similar to other emerging markets pharmaceutical companies, Ache has a narrower R&D product pipeline than those of its multinational competitors and a weaker portfolio of patented products.

Positively, the company's exposure to licensing agreements is low, representing less than 8% of revenue. Ache has consistently increased efforts to innovate and renovate its product portfolio by investing, on average, around 2.5% of revenue in R&D. Fitch expects product launches in 2021, as a percentage of revenue, to be in line with the 21% average between 2010 and 2019.

Limited Pandemic Effects: Ache's operating performance has remained mainly robust during the pandemic, demonstrating defensive qualities and flexible portfolio mix. We observed some demand imbalances linked to the pandemic, with increasing demand for critical drugs at the beginning of the lockdown.

This was followed by weaker demand for elective treatments, which gradually recovered as lockdown measures eased in 2H20. Ache felt these effects mainly on its respiratory RX portfolio, which had volumes slightly below 10% of 2019. According to Fitch's forecast for YE 2020, a change in product mix will drive volumes down by 8% but revenue up by 3% to 4%.

Competition Remains Tight: Competition is increasing, with local pharmaceutical companies consolidating brands, expanding product reach across segments or therapeutic classes, and with aggressive commercial conditions. Fitch expects Ache's EBITDA margin to be slightly pressured in 2021, at around 27%, from 30% expected for 2020 and an average of 29% between 2015 and 2019. This is as the company seeks to increase its presence on generics and OTC markets.

Margins will remain adequate compared with the industry average and revert back to between 29% and 30% from 2022 onward. The base case scenario considers an EBITDA of BRL1.04 billion in 2020 and BRL1.05 billion in 2021. Higher EBITDA margin in 2020 results from a different portfolio mix and lower sale expenses, as online doctor visits increased due to the pandemic.

Pre-Dividend FCF to Remain Sound: Ache should continue to present robust pre-dividend FCF in the future. Fitch forecasts cash flow from operations (CFFO) of BRL567 million in 2020, increasing to BRL705 million in 2021 and with a growing trend in the following years, sufficient to cover expected capex.

We forecast total capex at BRL773 million in 2020-2022, mostly related to the new plant in Pernambuco, which will lead to around 50% expansion in the company's production capacity. The base case scenario estimates negative FCFs of BRL101 million and BRL153 million in 2020 and 2021, respectively, with positive FCF from 2022 on. Fitch estimates average annual dividends of BRL530 million from 2020 to 2022, corresponding to, approximately, 70% of net income.

Unleveraged Capital Structure: Ache has maintained low leverage ratios and strong credit metrics. Fitch's base case scenario projects net debt/EBITDA below 0.6x and FFO leverage between 0.5x and 1.0x in the next four years. This scenario already considers investments for the new facility and high dividend payouts. In the past four years, the company's average FFO leverage was 0.5x and the net debt/EBITDA ratio was 0.2x

Derivation Summary

Ache's LC IDR and National Scale Rating reflect the defensive nature of the pharmaceutical industry, the company's leading position in the prescription drug segment and its low product portfolio risk, with no exposure to patents or licenses. Ache's lack of geographic diversification, smaller scale, relatively narrow research portfolio and credit access/financial flexibility compared with top pharmaceutical companies constrain its 'BBB' LC IDR. Ache is well-positioned in terms of leverage compared with most of the top global pharmaceutical issuers that are rated 'A' or 'AA' by Fitch, with average net leverage of 1.5x.

Ache's National Scale Rating is positioned two notches higher than Blau Farmaceutica (AA[bra]/Stable). Compared with Ache, Blau has limited operational scale; revenue concentration in a few products, with a focus on the nonretail segment; and high exposure to the public sector. Both companies have a deleveraged capital structure, with similar operating margins.

Ache's business resilience to economic cycles, strong CFFO generation, financial flexibility and unleveraged capital structure stand out among peers. Ache's capital structure has consistently been stronger than Fitch's 'BBB' portfolio. Ache's operations are concentrated in Brazil and the lack of operating and financial assets abroad cap its FC IDR at the Brazilian Country Ceiling of 'BB'.

Key Assumptions

Fitch's Key Assumptions Within Our Rating Case for the Issuer Include

-- Average revenue growth of 9.0% from 2020 to 2023.

-- Innovation to continue to represent around 18% of net revenue, with R&D expenses ranging around 2.5% of net revenue.

-- Capex of BRL773 million in 2020-2022, which includes investments in the new plant in Pernambuco.

-- Dividend payouts of between 75% and 80% of net income, on average.

RATING SENSITIVITIES

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

-- For the FC and LC IDRs, positive rating actions are limited by Brazil's Country Ceiling of 'BB' and Sovereign Rating of 'BB-'.

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

-- Ache's credit ratios are very strong at the current rating level but unexpected events that move net debt/EBITDA beyond 2.0x or FFO-adjusted leverage beyond 3.0x could result in negative rating action for the LC IDR.

-- Significant market share or brand deterioration.

-- Further negative rating action on Brazil's Sovereign Rating and Country Ceiling could result in negative rating action on Ache's FC and LC IDRs.

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

Manageable Liquidity: Ache has historically maintained a robust liquidity position. Ache reported cash and marketable securities of BRL272 million and short-term debt of BRL507 million, due to a short-term working capital facility, as of Sept. 30, 2020. Fitch views this reduction of cash balance coverage of short-term debt as temporary and expects a return to more than 1.0x in the next three years.

Positively, the company also has a revolving credit facility undrawn balance of BRL300 million and a flexible dividend payment to manage cash needs. Ache's total debt of BRL876 million was comprised of Banco Nacional de Desenvolvimento Economico e Social (BNDES) lines (46%), working capital (47%), and others (7%).

Sources of Information

Ache Laboratorios Farmaceuticos S.A.

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 Environmental, Social and Corporate Governance (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.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
Ache Laboratorios Farmaceuticos S.A.	LT IDR	BB	Affirmed		BB
	LC LT IDR	BBB	Affirmed		BBB
	Natl LT	AAA(bra)	Affirmed		AAA(bra)

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Corporate Rating Criteria (pub.21 Dec 2020) (including rating assumption sensitivity)

Metodologia de Ratings em Escala Nacional (pub.22 Dec 2020)

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)

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