MOODY'S
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Rating Action: Moody's assigns B2 rating to Doc Generici; stable outlook

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Paris, June 11, 2019 -- Moody's Investors Service ("Moody's") has today assigned a B2 Corporate Family rating (CFR) and a B2-PD probability of default rating (PDR) to Diocle S.p.A. ("Doc Generici"). Concurrently, Moody's has assigned B2 instrument rating to the proposed €470 million senior secured notes issued by Diocle S.p.A. The outlook is stable.

RATINGS RATIONALE

The B2 CFR assigned to Doc Generici reflects (1) the company's strong positioning in the Italian retail market where market fundamentals are positive supporting Moody's expectations of further volume penetration for generics players; (2) overall high barriers to entry; (3) its broad product portfolio across several therapeutic categories and products, with limited concentration; (4) strong cash flow generation that will underpin a solid liquidity profile and drive deleveraging over the next two years; (5) strong track record of profitable growth supporting deleveraging; (6) an exposure to M&A risk which Moody's considers to be lower than that of some of its peers which pursue a more pan-European strategy.

On the negative side, the B2 CFR also reflects (1) the company's limited scale with revenues amounting to €208 million in 2018; (2) its weak geographic diversification profile, which makes the company vulnerable to potential changes in the Italian regulatory environment; (3) its LBO capital structure, where Moody's expects leverage -- defined as Moody's adjusted (gross) debt/ EBITDA ratio -- to remain above 5x over the next 12-18 months; (4) an asset light structure, which could render the company vulnerable to shortages/ disruptions in supply chain; (5) some uncertainty and risk related to ongoing liberalization of the Italian pharmacy market which may see a higher number of pharmacy chains establishing over time; (6) a covenant light structure including restricted payment tests that could allow for potential re-leveraging of the balance sheet again.

Doc Generici benefits from substantial barriers to entry. The Italian generics market is split in between the retail pharmacy market and the hospital market. Doc Generici only competes in the pharmacy market and maintains a salesforce that can cater to both pharmacies and physicians. Contrasting a number of other European generics market -- which may have different forms of distribution channels and/ or forms of procurement -- the Italian retail market is largely consolidated with the largest five players maintaining fairly stable market shares over time and representing close to 80% of the market by value. The barrier to entry is further enhanced by local jurisdiction that prevents price competition at the point of sale. In addition, Moody's understands that most pharmacies tend to have only three or four suppliers of drugs emphasizing the importance of being able to supply a broad range of portfolio products across a number of therapeutic areas. The risk of emerging competition is therefore in Moody's view more likely to come from niche players that are unlikely to threaten large parts of Doc Generici's current business.

Volume growth for generics players operating in the Italian market will continue to be fuelled by an improving generics penetration which provides with a favorable backdrop. This is partly driven by social factors namely demographics as an ageing population needs more medical treatment. However, this evolution is slow and Doc Generici -- operating only in the Italian market -- remains vulnerable to changes in the regulatory framework that could hamper its growth prospects. Such risk could materialize through a number of factors including changes to the ways drugs are reimbursed and/ or opening up for higher discounts to pharmacies (currently fixed at 8%), development of pharmacy chains that may influence competition -- other than price -- at point of sale, alternative ways of procurement -- such as increased usage of tenders -- which would likely increase pricing competition in the market. These risks -- more than its modest size -- are weighing on Doc Generici's credit quality. Moody's acknowledges, however, that new policies and regulations in Europe generally seek to increase the use and penetration of generics rather than the opposite. From a governance point of view, the company is controlled by ICG and Merieux Equity partners which controls the board with more than 95% ownership. As is often the case in highly levered, private equity sponsored deals, owners have a high tolerance for leverage/risk and governance is comparatively less transparent, a credit negative. Moody's has factored these considerations into its assessment of the credit risk associated with Doc Generici.

--B2 rating assigned to proposed notes

The B2 rating assigned to the proposed notes reflects the instrument's positioning in the waterfall ranking behind a €50 million super senior revolving credit facility (SSRCF). Moody's understands that Diocle Bidco and Doc Generici will provide with upstream guarantees following closing of the transaction. However, this may take some time to put in place and -- prior to the completion of this merger -- the senior notes will be subordinated to liabilities such as trade payables at the operating companies. The B2-PD PDR reflects Moody's assumption of a 50% recovery rate in line with the rating agency's practice for covenant light structures.

--LIQUIDITY

Moody's expects the liquidity profile of Doc Generici to be good over the next 12-18 months. Whereas the company will have limited cash on balance sheet post closing, further liquidity cushion is provided by the company's undrawn €50 million SSRCF and Moody's expectations of free cash flows exceeding €30 million per annum. Doc Generici pursues an asset light model with limited amounts required for capital expenditure. Moreover, working capital swings are generally modest although Moody's cautions that Doc Generici's extensive use of wholesalers could in more extreme scenarios entail larger working capital swings should the wholesalers draw on their inventory levels rather than place new orders. The SSRCF has a financial maintenance covenant which will only be tested when the facility is drawn by 40% or more. However, the testing requirement is so loose that Doc Generic is unlikely to face difficulties in complying with it.

--STABLE OUTLOOK

The stable outlook reflects Moody's expectations that Doc Generici will continue its strong track record of organic growth in sales and EBITDA allowing for its leverage to move towards 5x over time. The stable outlook also incorporates Moody's assessment that M&A event risk is somewhat lower for Doc Generici in view of its core focus being on the consolidated Italian market where Moody's would expect acquisitions, if any, to be more bolt-on in nature. Lastly, the stable outlook reflects the agency's expectations that Doc Generici will not distribute funds to shareholders until credit metrics have improved well below the parameters set for the B2 rating category.

--WHAT COULD CHANGE THE RATING UP/ DOWN

For upward pressure to materialize, Doc Generici would have to increase its scale and improve its diversification through, for example, a reduced reliance on the Italian market. Quantitatively, an upgrade could be considered if the company's leverage (defined as Moody's (gross) adjusted debt/EBITDA) ratio trends below 4x.

Downward pressure could develop should the leverage ratio (defined as Moody's (gross) adjusted debt/ EBITDA) fails to show a glidepath towards 5x over time. Downward pressure could also develop should there be unfavorable developments in the Italian regulatory framework affecting materially the company's ability to drive earnings and cash flow growth. Lastly, larger debt funded M&A transactions and/ or shareholder distributions could prove negative for the outlook or the rating unless the company has already deleveraged substantially.

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Pharmaceutical Industry published in June 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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