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US drug manufacturers under pricing pressure

by Crystopaz ANGGA

The downfall of Valeant marked a watershed moment for the pharmaceutical industry in the US. As some drug manufacturers, such as Valeant, Turing, and Mylan, have drawn a fiery backlash over outrageous price hikes, other drug manufacturers have shown restraint in increasing drug prices. Amid pressure on drug prices, close scrutiny from regulators, and an increasing number of litigations against drug companies, the NYSE ARCA pharmaceutical index has tumbled 11.5% year-to-date.

Mylan NV, a generic and specialty pharmaceutical company in the US, is the latest in a string of companies that have come under fire for inflating drug prices. Beside increasing the price of the anti-allergy EpiPen six-fold, the company has also been accused by lawmakers of misclassifying its EpiPen product as a generic drug rather than a specialty drug, allowing the company to overcharge the government's Medicaid program. In the face of searing criticism and the potential launch of EpiPen's competitor, Mylan launched a generic version of EpiPen at half the price of the original.

Mylan's case marks the end of Valeant's business cookbook that is widely practiced in the industry: acquire more companies and inflate drug prices. In October, US drug distributor McKesson voiced an ominous concern about drug price erosion as the company missed its sales forecast due to moderating drug prices. In response to public backlash over skyrocketing drug price, two major drug companies, Novo Nordisk and Allergen, have committed to a single digit price increase, putting pressure on other drug manufacturers to follow suit.

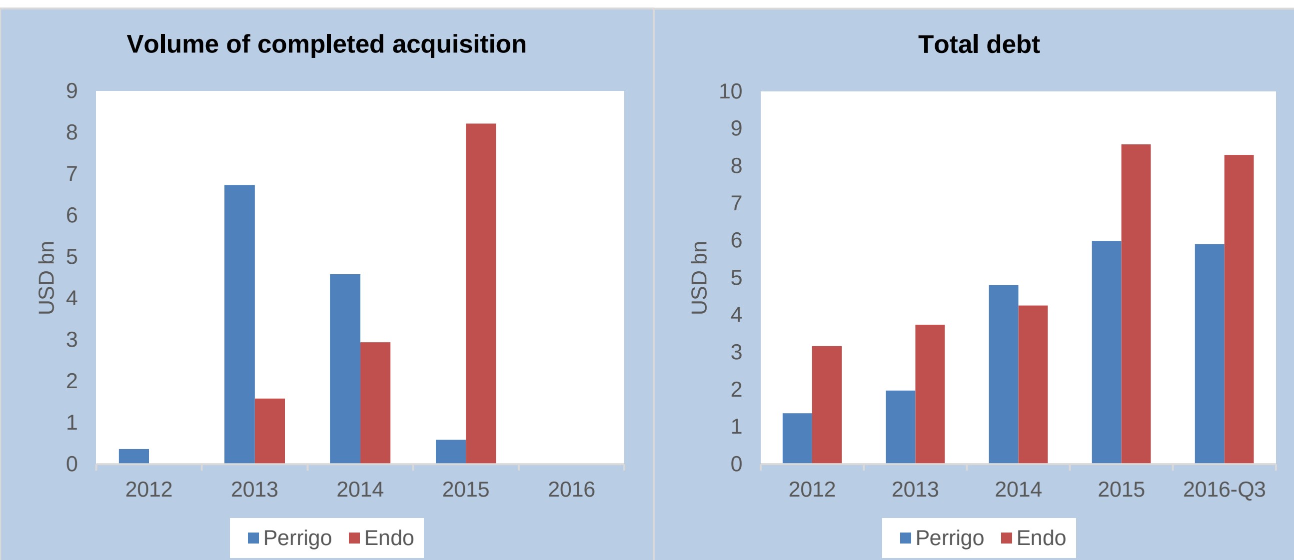

Figure 1: M&A volume of Perrigo Co PLC and Endo International (left panel); total debt of Perrigo PLC and Endo International (right panel). *Source: Bloomberg*

Drug price erosion is bringing the acquisition-fueled growth to a halt after years of rapid growth in the pharmaceutical sector. Endo International, which has made USD 12bn worth of acquisitions in the past four years, bore the brunt of adopting Valeant's debt-fueled acquisitions (see Figure 1). In May, the company significantly reduced its 2016 revenue guidance by USD 500mn due to increased competition from generic products, delayed FDA approvals, and price erosion in the generic sector, causing a 40% plunge in its stock price. Following the announcement, Moody's downgraded Endo's corporate family rating to B1 from Ba3 with a negative outlook, citing Endo's limited ability to deleverage amid challenging business condition and constrained cash flow. In line with the deteriorating credit health, the RMI-CRI 1-year probability of default (PD) of Endo International surged from 82bps in January to 1095bps in June before declining to 439bps in November.

Similarly, Perrigo, a generic and over-the-counter drug producer which had completed USD 12bn acquisition deals in the past four years (see Figure 1), has also suffered from price erosion in its prescription drug segment. The company reported sales below Wall Street's expectation in the second quarter and lowered its EPS guidance in 2016. Perrigo's CEO predicted that price erosion will continue in the second half of 2016 at a rate of 9% to 10%. Amid weakness in the generic pharmaceutical segment and acquisition missteps in Europe, S&P lowered Perrigo's corporate credit rating to BBB- from BBB in April. In August, Moody's also changed the company's outlook to negative while affirming its Baa3 rating, citing relatively high adjusted debt to EBITDA ratio of around 4.0x and stalling growth in earnings.

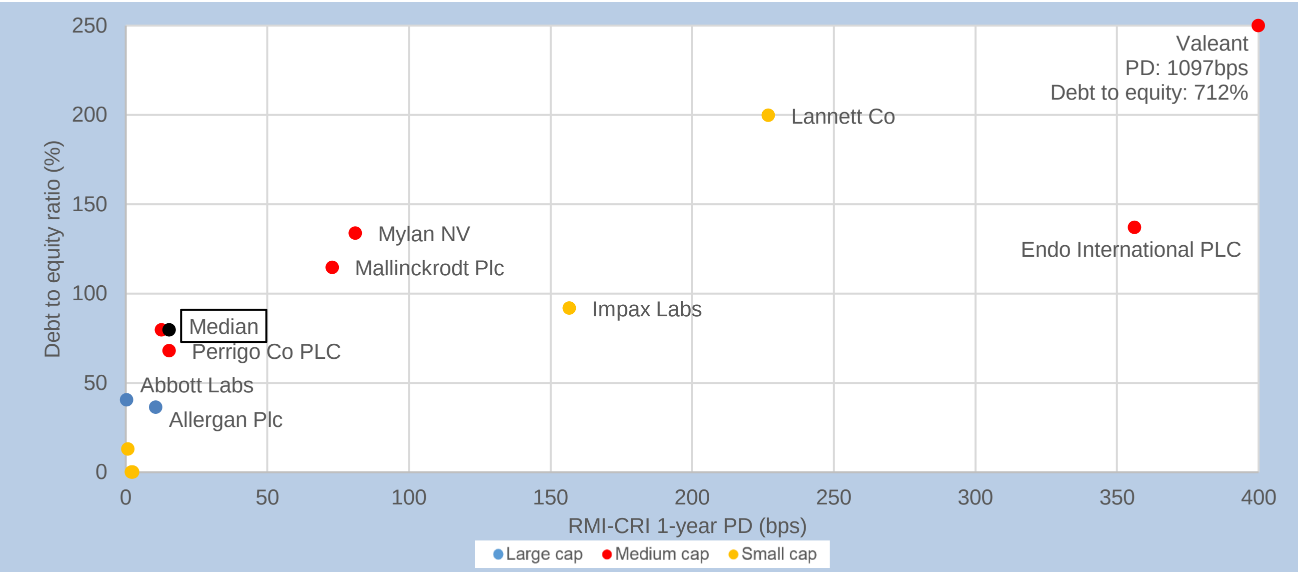

Figure 2: RMI-CRI 1-year PD of 14 specialty and generic pharmaceutical companies on November 30th and debt-to equity ratio reported in Q3. *Source: RMI-CRI, Bloomberg*

The RMI-CRI 1-year PD of 14 US specialty and generic pharmaceutical companies on November 30th reveals heightened credit risk in the specialty and generic drug industry. Medium cap companies, such as Mylan, Endo, and Valeant, which have made sizable acquisitions in the past few years and received subpoena over their pricing practice, exhibit significantly higher PD and leverage above the median (see Figure 2). Smaller generic companies, such as Lannet and Impax, which reported losses in in the third quarter and received subpoenae over price-fixing allegation also display higher vulnerability in their credit risk (see Figure 2). On the other hand, large diversified pharma companies, such as Abbott and Allergan, outperform their peers with lower PDs and leverage (see Figure 2).

The recent lawsuit filed against Teva, Mylan, and four smaller generic drug companies over generic drug price fixing will continue to be a drag in the generic drug segment. Mylan NV, which reported a Q3 loss due to a USD 465mn settlement with the US Department of Justice over the EpiPen classification case, is likely to face more headwinds in the form of litigation charges. More importantly, the collusion lawsuit can potentially implicate more generic drug manufacturers and prompt more regulations over drug prices, putting greater pressure on generic drug prices.

In the face of debt overhang, medium cap generic and specialty drug manufacturers are steering away from big M&As. The number of M&A deals in the US pharmaceutical sector has significantly declined in 2016 after peaking in 2014. Saddled with debt, many drug producers are now focusing to deleverage and integrate their newly-acquired businesses. Moving forward, the continued scrutiny on drug prices would continue to pressure generic drug makers' operating margin. Medium cap specialty and generic drug companies, in particular, would need to translate their big past acquisitions into realized growth in order to recover and successfully deleverage.

Credit News

Oil industry on the cusp of cash flow recovery

Dec 19. In a report produced by energy consultancy firm Wood Mackenzie, the world's major oil and gas companies will turn cash flow positive for the first time in three years in 2017 if the OPEC production cartel succeeds in keeping the oil prices above USD 55-per-barrel. According to Wood Mackenzie's head of corporate research, deep cost cuts in the midst of the oil rout, compounded with a gradual improvement in oil prices, were beginning to alleviate pressure on companies' balance sheets. The return of the reckless spending during the USD 100-per-barrel oil era was warned by Wood Mackenzie, adding that capital discipline would continue to frame corporate strategies in 2017, with the higher earnings from higher prices being committed to paring back on heavy debts accumulated during the past two years. (FT)

Bond selloff shows risks of China's efforts to restrain credit

Dec 18. China's distressed bond market underscores the difficulty of holding the reins on easy credit that expanded the country's indebtedness over the past decade. A mini-rout in China's bond market, following a gradual tightening of short-term credit by China's central bank, coupled with rumors of liquidity squeezes at brokers, pressed authorities to inject USD 86bn in short and medium-term funds. The bond selloff sparked concerns over the stability of China's opaque and deeply intertwined credit markets. According to a partner at Shanghai Yaozhi Asset Management Co., which holds USD 2.9mn in debt, "everyone is nervous". (WSJ)

Fed lifts rates, sees faster pace of hikes in Trump's first year

Dec 15. The US Federal Reserve raised interest rates on last Wednesday and signaled a faster pace of increases in 2017. The decision comes in the wake of the incoming Trump administration's promises of tax cuts, spending and deregulation. The increase in the federal funds rate to a range of between 0.50% and 0.75% was widely expected. The prospect of a brisker monetary tightening, however, contributed to a selloff in shorter-dated US Treasuries and stocks. Yields on shorter-dated Treasuries hit their highest levels in more than five years and US stocks fell in choppy action. The dollar rose against a basket of currencies, gold hit its lowest level in more than 10 months and oil prices also declined. The rate increase was the first since last December and only the second since the Global Financial Crisis. (Reuters)

Moody's flags high debt risks facing Asia-Pacific nations

Dec 15. According to Moody's Investors Service, high debt levels and global financial linkages spell vulnerability for a number of Asia-Pacific nations. This comes amid a marked fall in financial asset prices in the Asia-Pacific since the United States presidential election last month. In a report, Moody's noted that regional currencies have depreciated against the US dollar, while equity prices have fallen and portfolio flows have reversed. Capital outflows or lower inflows correspond to a tightening in domestic financing conditions, which could exacerbate difficulties of Asian countries to meet their current account and external debt payment obligations. This is particularly so if the domestic authorities are constrained in their ability to use fiscal and monetary tools to offset the tightening impact of global financial conditions. (Straits Times)

Optima Specialty Steel seeks bankruptcy protection

Dec 15. Optima Specialty Steel filed for chapter 11 bankruptcy protection as nearly USD 172mn in senior secured note debt came due. The bankruptcy filing is designed to keep the specialty steelmaking operations in business, while Optima works out a reorganization plan that gets its debt in line with revenue. In the past decade, the firm collected US steelmaking operations in leveraged buyouts. However, Optima recently has to grapple with low prices and weak demand from the energy, agriculture and mining sectors. In addition to the senior secured notes, Optima faces a December 30 deadline on USD 87.5mn of senior unsecured note debt as well. (WSJ)

Peabody wins approval to repay bankruptcy loan early (Reuters)

Stone Energy files for bankruptcy to restructure its debts (Market Watch)

Negative outlook for Singapore banks, says Fitch (Straits Times)

Regulatory Updates

US Fed adopts bank rule to prevent government bailouts

Dec 16. The Federal Reserve has adopted a new rule requiring US and foreign systemically-important banks to issue a minimum amount of long-term debt which can be converted to equity to support the bank in event of a bankruptcy. The capitalization requirement is one of the final banking reform steps to prevent government bailout of major banks following the 2008 Global Financial Crisis. The move will force banks to pre-fund losses using equity, imposing the cost on shareholders rather than taxpayers, who bailed out "Too Big to Fail Banks" in the previous financial crisis. The move also aims to motivate investors holding bank debt to monitor its operations more closely as they stand to be converted to equity holders if the bank fails. (Channel NewsAsia)

Wells Fargo fails 'living will' test, faces restrictions: US regulators

Dec 13. Wells Fargo has been blocked from establishing international bank entities or acquiring any non-bank entities, effectively limiting its business growth after the bank failed the 'living will' test. The test is designed to gauge the bank's ability to dismantle itself orderly in the event of a bankruptcy. The ruling follows an earlier scandal in which two million bank accounts were created without customer's consent, although no connection exists between the two events. To pass the test, the bank must now outline a simpler legal structure to wind down the bank within two years, or risk having to downsize. Other banks which failed the previous test in April -- State Street, JP Morgan & Chase, Bank of New York Mellon and Bank of America – all passed the latest round of tests. The living will test was conceived in the wake of the 2008 financial crisis. (Reuters)

Riskiest financial groups should pay more into compensation scheme, says FCA (FT)

MOF rejects claim of Singapore as tax haven (Straits Times)

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