



Ailing generics giant finding a formula for its own cure

by [Lu Chang](#)

Teva Pharmaceutical Industries Ltd, the largest generic drug maker in the world, has been plagued by a series of problems lately ranging from [squeezed margins in the US generics market](#) to the [leadership vacuum](#) that currently still exists in the company. Share price of the Israeli company plunged on [reports of missed earnings and slashed dividends](#) for the second quarter of 2017. Furthermore, these problems were compounded by a rising debt level after the [acquisition of Actavis in 2016](#). In an increasingly competitive landscape for generic medicine, Teva is struggling to maintain its profitability against smaller players that compete on price. The [imminent expiration of patents on specialty drug](#) also threatens the stability of Teva's revenue stream. Credit outlook of Teva had worsened under such circumstances and the company is under pressure to formulate a new strategy in response to the deteriorating conditions.

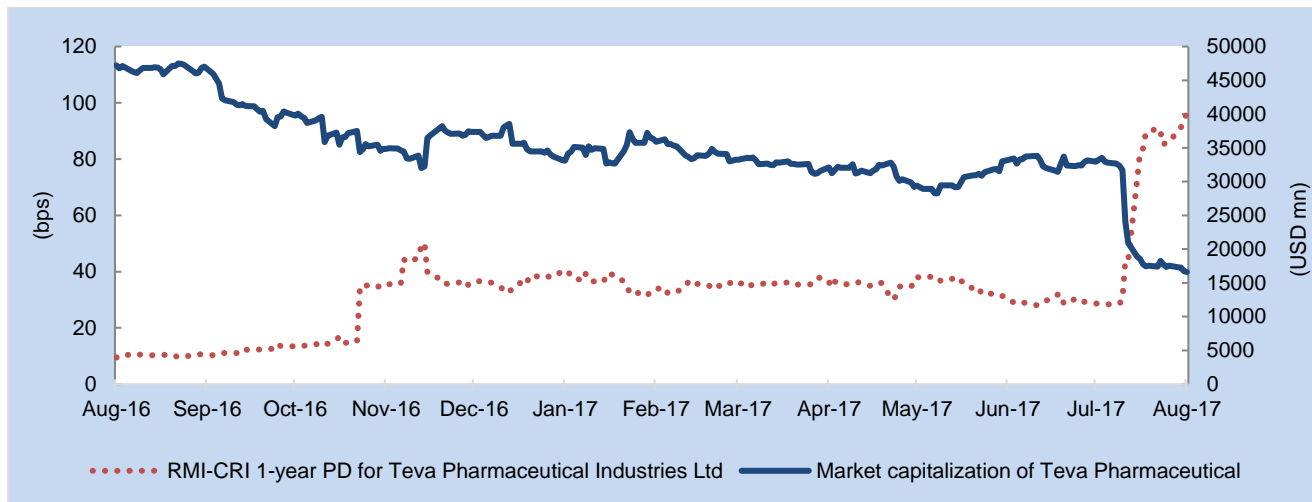


Figure 1: RMI-CRI 1-year PD (LHS) and market capitalization (RHS) of Teva Pharmaceutical, Source: RMI-CRI, Bloomberg

The announcement of missed earnings in Jul 2017 resulted in the 47.6% decline in the market capitalization of Teva. The RMI-CRI 1-year Probability of Default (PD) spiked to an all-time high of 96.64 bps in Aug 2017. A combination of factors had led to the fading confidence among investors. While the market for generics remains large in the US, it is widely believed that Teva is unable to retain its competitive edge due to new FDA regulations aimed at introducing more competition in the generics market.

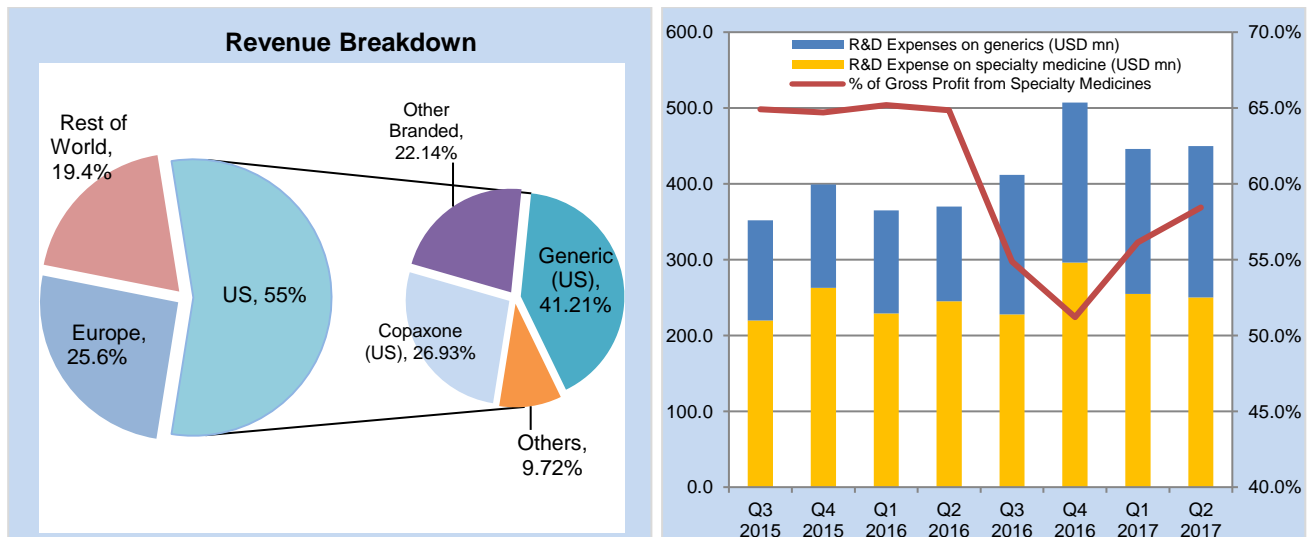


Figure 2 & 3: Revenue breakdown and profit and expenditure trend of Teva Pharmaceutical, Source: Bloomberg

Teva currently owns a portfolio of more than 1000 molecules for its generic drug operations which accounts for approximately half of Teva's revenue. The rest of Teva's revenue is predominantly generated by its investments in specialty medicine for disorders in the central nervous system. By geographically distribution, US is the biggest market for Teva, accounting for 55% of Teva's total sales (See figure 2).

Traditionally, generic drug makers had taken advantage of the patent cliff when the patent of a drug first expires. The first in the market to produce a generic copy enjoys a period of exclusivity mandated by the [Hatch Waxman Act of 1984](#) and are able to charge prices close to the branded original. However, the first generic advantage is gradually losing its edge as the next batch of drugs to lose their patents mainly consists of biological medicine that is hard to imitate. Biosimilars, which are generics of biological medicine, are possible but their production process will be complex and costly. Teva's conventional approach for being the first generic in the market is starting to lose its effects as [biosimilars may not be well-received with doctors](#) for they are not identical as their branded counterparts.

Margins of large generics manufacturers have also been squeezed due to the liberation of the US drugs market. With the appointment of a new FDA commissioner, Scott Gottlieb, there had been [changes in the policy stance towards generic drugs](#). Gottlieb pledged to open up more competition through reforms in the generics market, allowing more players in the market to effectively bring down drug prices for end consumers. Gottlieb is rallying to [reduce the review period of a generic drug](#) from 4 years to roughly 10 months. In doing so, smaller players are able to produce products they previously could not due to the long review period.

Concurrently, the specialty medicine business of Teva is facing tough times as well. Approvals have been granted by the FDA for generic drug producers to manufacture alternate versions of Teva's bestseller, Copaxone. Copaxone alone accounts for 26.93% of sales in the US and 18% of Teva's total revenue. This percentage is down from 23% a year ago after the 20mg generic version had been introduced to the market. Approval for the more widely used 40mg Copaxone generic is pending and Teva's revenue is expected to [slide further when the 40mg version is introduced into the market](#) by competitors.

The situation of oversupply in the generics market is coupled with a consolidation in demand. This consolidation is led by large wholesalers and drugstores that joined forces to form purchasing organizations. These organizations command significant bargaining power to negotiate for huge discounts from drug manufacturers like Teva. Apart from the worsening external environment, Teva faces [internal issues with regards to its company management](#). The company was left with a leadership vacuum since the previous CEO was ousted 6 months ago. The board is currently in search for its fifth CEO since 2012, reflecting ingrained problems with the company's management.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017	Q2 2017
EBITDA (USD mn)	1,470	671	1,342	195	1,375	-5,163
Profit Margin (%)	13.22	5.04	7.40	-14.98	11.45	-104.99
Net Debt (USD mn)	4,236	3,934	35,298	34,810	33,736	34,453
Current Ratio	1.31	1.27	0.90	0.91	0.93	0.94

Figure 4: Current financial snapshot of Teva Pharmaceutical, *Source: Bloomberg*

Examining the credit profit of Teva, the company's credit position deteriorated after the mistimed acquisition of Allergan's generics unit, Actavis, at a time when the generics market was headed for a down turn. [The USD 41bn acquisition](#) had strained Teva's balance sheet severely with net debt jumping to USD 35.2bn in Q3 2016 from USD 3.9bn in Q2 2016. Analysts felt that Teva had grossly overpaid for the acquisition without achieving the cost synergies expected from the acquisition.

The company's credit rating is at Baa3 currently, which is only one grade above the junk range. Yields on Teva's bonds rose after the company warned that it may breach [certain bond covenants](#) should the decline in earnings continue to worsen. Existing covenants require Teva to maintain a net debt to EBITDA ratio of below 4.25. Current net debt to EBITDA ratio of Teva is at 4.56 times and the company is seeking approvals from bondholders to amend this covenant. In response to the worsening credit conditions, Teva planned on [divesting some of its assets](#) to raise around USD 2bn in a bid to reduce its debt load. Dividend payment is also slated to be slashed by 75% alongside with cost-cutting measures such as exiting underperforming markets. In 2017 alone, Teva plans to exit 45 nations and close down 15 plants.

Teva's performance is heavily linked to laws governing the patents on drugs. Under an unfavorable regulatory environment, there had been calls for Teva to transit further into the area of specialty medicine considering the diminishing profitability in generics. Teva is currently [looking for partners to fund the development of new drugs](#) as it does not have the capital buffer to take on risky ventures given its current credit situation. Total R&D expenses had increased over the past quarters, but percentage of expenses dedicated to specialty medicine and its contributions to gross profits had continued to decline (See figure 3). Teva's problem is a complex one and it needs to strike a balance between investing in future growth and managing its current debt levels. The question remains on whether it can find the formula to cure its problems before mounting debt levels and plunging profits crush the company.

Credit News

World's biggest banks square off over Noble credit default swaps

Aug 27. The plight of heavily indebted Noble Group is causing a dispute between some of the world's biggest investment banks over credit default swaps written against the troubled commodity trader's borrowings. The dispute rippled through debt markets after banks and funds served notice to sellers of CDS protection, which pays out in the event of a default. They claimed that a recent extension to Noble's loan repayment terms amounted to a debt restructuring. The move was unusual, as the CDS market has agreed since the financial crisis to rely on the rulings of the ISDA, which had failed to determine if Noble Group was in default or not, creating a vacuum that allowed bilateral claims to proliferate across the market. It is believed that the net total owed by sellers of CDS protection on Noble could be up to USD 157mn. ([FT](#))

Russia prepares rescue package for Otkritie

Aug 26. Russian regulators are preparing a rescue package to save Otkritie, the country's largest privately held lender as a liquidity crisis enfolds. In the last two months, Otkritie lost USD 10.4bn in deposits, which accounted for 20% of its balance sheet. Several senior managers have withdrawn personal funds from the company and a large shareholders plan to stop additional investments, made the situation even worse. A "bail-in" regime introduced in the country in May allowed the central bank to take control of Otkritie, but the decision has not been made yet. If it did, the rescue package may cost USD 14bn. The shares in Otkritie dropped 8% after the plan was reported. ([FT](#))

Hertz falls as analyst says revoked bond deal risks default

Aug 26. Hertz Global Holdings Inc. shares plunged 11% after Xtract Research analyst Valerie Potenza wrote in a report that Hertz's reneged plan to refinance USD 450mm in bonds may have violated covenants. As Hertz told investors it planned to redeem the notes maturing in 2019 the move of refinancing could constitute a default on that debt. Hertz's spokeswoman Karen Drake declined to comment. The analyst opined that as long as the bondholders believe Hertz can survive, they would refrain from demanding payment, as there are two more coupon payments due. About two thirds of the company's stock value was lost over the last year. ([Bloomberg](#))

Kenya Airways wins battle with banks on loan restructuring

Aug 26. The court has ruled for Kenya Airways to proceed with its restructuring plan after three of the eleven local lenders opposed the proposal. The three lenders, which had lent USD 60.6mn, had opposed to the plan, as they claimed that the arrangement was a formality rather than a discussion. Based on Kenya Airways' restructuring plan, the eleven lenders will hold a 37% stake in the national carrier after the conversion of debt into equity. The airline, the banks and the government, which owns a 29.8% stake of the national carrier, have been ordered to hold joint meetings to carry out the restructuring. ([The Standard](#))

White House snub sends coal miner Murray Energy's bonds plunging

Aug 24. Bonds of Murray Energy Corp. dropped deeper into distress after the Trump administration refused the coal miner's request for an order that could help the firm avoid bankruptcy. According to Trace, Murray's 2021 11.25% bond fell more than 7 cents on the dollar as millions of debt payments are due at the end of September. Even though Murray, the largest private coal producer in the US, kept seeking for help, it said that the payments would be impossible if some of its main clients went bankrupt. Trump has long vowed to support the coal industry, but the White House's denial limited his ability. ([Bloomberg](#))

Judge approves Avaya's disclosures for Chapter 11 restructuring plan ([Reuters](#))

Mexico's ICA says filed pre-packaged bankruptcy plan ([Reuters](#))

Seadrill, a big offshore oil player, to seek bankruptcy protection ([WSJ](#))

Regulatory Updates**The Fed ponders the fractious politics of debt**

Aug 25. The Federal Reserve would have to contend with renewed political risk in the US Treasury market as the US Congress has not raised the "debt ceiling" before its deadline in late September. Fraught relations between President Trump, Senate leader Mitch McConnell and the Republican Congress has delayed the progress as certain parties do not agree with the notion to allow the US government to continue financing itself. The President threatened to close down the government if he did not have the capital to build his Mexican Wall while the Senate leader said there would be no chance the debt ceiling would be raised. After receiving criticism over the bank's quantitative easing policies, the Fed Chairman now faces a difficult task of communicating the bank's intention to the market in the midst of political disorder. ([FT](#))

European junk bond market faces September LBO test

Aug 23. Bankers are ready for more large leveraged buyout deals (LBO) which will test the resilience of the market's strong rally. As a result of the stimulus efforts by the European Central Bank, the European high-yield market has performed strongly over the past 18 months. The LBO test could coincide with the end of the market's customary August shutdown as bankers prepare to market LBO deals in both high-yield bonds and leveraged loans. There is a big supply of loans and bonds waiting to be launched in September that includes the largest leveraged buyout of a European listed company in four years. If all the potential deals do hit the market, it could outpace all of the high-yield LBO supply seen to date in 2017. ([FT](#))

India turns up pressure with Name and Shame default strategy ([Reuters](#))

Bill to streamline insolvency framework to be introduced in 2018 ([Straits Times](#))