



Soaring leverage and upswing in debt-funded M&A casts shadow over US pharmaceuticals' credit outlook

by [Tian Mengxi](#)

- The NUS-CRI Agg PD highlights the growing divergence between the credit risk profiles of the US pharmaceutical industry and their global counterparts
- The NUS-CRI Forward 1-year Agg PD of US pharmaceuticals has deteriorated since Jul-2020, primarily on the back of the debt financing boom, pricing pressure due to regulatory reforms, and a potential upswing in debt-funded M&A activity

As shown by the NUS-CRI 1-year Aggregate (median) Probability of Default (PD) (See Figure 1a), the credit risk profile of US-domiciled pharmaceutical companies¹ (US pharmaceuticals) has gradually deteriorated since 2015, driven by a surge in debt issuance and growing tolerance for higher financial leverage. The US pharmaceuticals have historically been a world leader in the industry's global landscape, accounting for [more than 40%](#) of global sales in 2017. Although the industry is expected to retain this leading position, the US government's plan to implement cost control policies could substantially strain profitability and continue to weaken the industry's credit outlook and strength relative to the global median. A potential rebound in debt-financed M&A activity, as well as pricing pressure due to the potential heightened regulation towards drug pricing, could also pose significant challenges to the industry's credit risk outlook in the medium term.

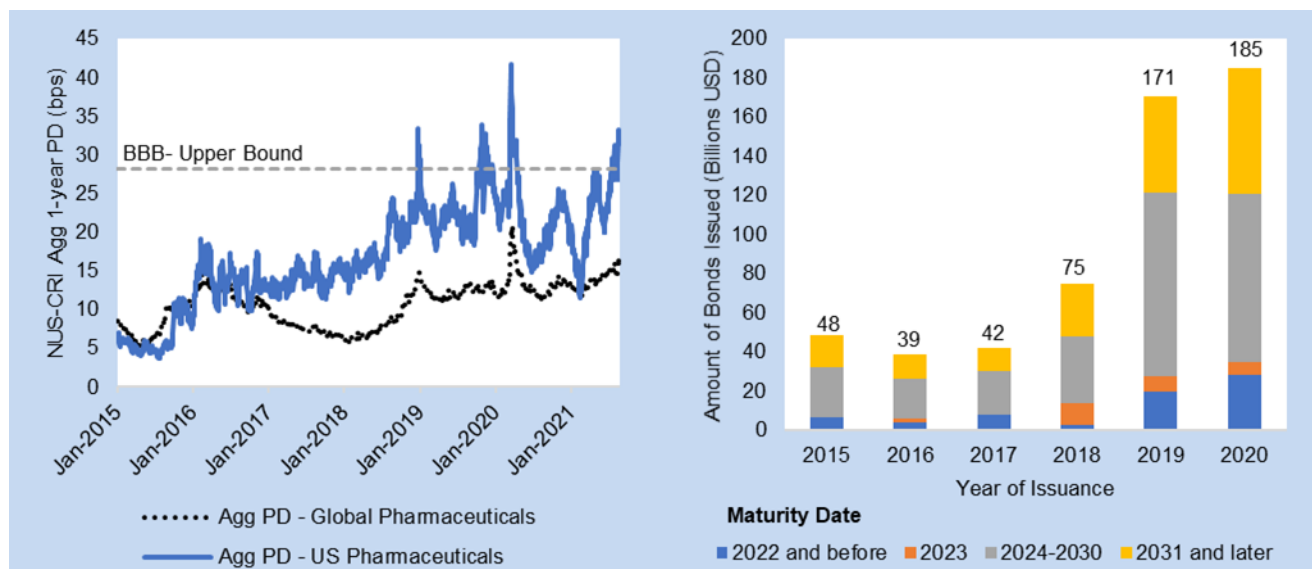


Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for US-domiciled and global pharmaceuticals from Jan-2015 to Aug-2021 with reference to PDiR2.0² bound. Figure 1b (RHS): Total amount of bonds issued by US pharmaceutical companies from 2015 to 2020 by maturity date. Source: NUS-CRI, Bloomberg

Debt issuance by US pharmaceuticals has been rising since 2017, reaching a peak of USD 185bn in FY 2020 (See Figure 1b). This uptick mirrors the surge in corporate debt globally amid the financing boom and easing of monetary policy by the Fed. Within the industry, the surge in debt issuance has mainly been driven by pharmaceutical companies issuing [larger debt offerings](#) to fund mega acquisitions, such as AbbVie and Bristol-Myers' USD 63bn and USD 74bn acquisitions respectively, as the industry saw a fall in the number of issuances, but a surge in the total amount of capital raised. As illustrated in Figure 1b, US pharmaceuticals are also taking

¹ The sample includes all 320 companies classified under the 'Pharmaceuticals' industry according to BICS 2007.

² The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

advantage of cheap borrowing costs to [extend](#) the maturity of their debt, as they shift towards bonds with repayment timelines that stretch out over a longer term.

Over the past few years, the US pharmaceutical industry has strayed from long-held norms of relatively conservative leverage. The Dow Jones US Select Pharmaceuticals Index³ (Ticker: [DJUSPR](#)) indicates that the reported total debt to total equity ratio⁴ has climbed up from 55.60% in FY2015 to 92.47% in FY2020, with net debt to EBITDA rising from 1.25x to 2.14x over the same period. As this trend seems to extend even [prior to 2015](#), the change could translate into a gradual shift in the rulebook of shareholders and company boards, increasing the industry's [tolerance](#) for a more levered capital structure.

Capital raising has improved the industry's liquidity profile, particularly after the onset of the COVID-19 pandemic: the median current ratio has inched up every quarter between Q1 2020 and Q2 2021, from 3.99x to 5.34x. However, this improvement in liquidity could also foreshadow a rebound in M&A activity, as the [top dozen](#) pharmaceutical companies now have more than USD 170bn in excess reserves that could be spent on M&A. US pharmaceutical companies face ongoing pressure to fill in gaps in their pipeline as their patents expire. For a select group of companies that face the risk of increasing product concentration, M&A could also pave the way for more diverse sources of revenue. Pfizer, for instance, may approach a patent cliff from [2026 to 2028](#), which if coupled with possible execution failures in its pipeline, could increase its appetite for M&A.

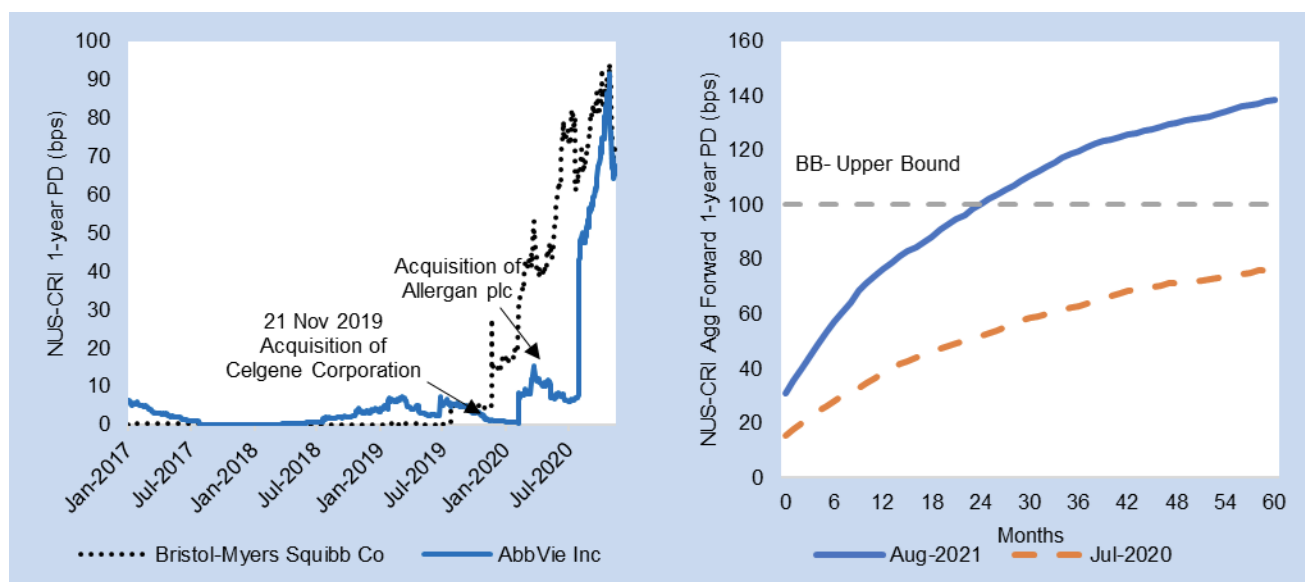


Figure 2a (LHS): NUS-CRI 1-year PD for Bristol-Myers Squibb Co and AbbVie Inc. from Jan-2017 to Aug-2021. Figure 2b (RHS): NUS-CRI Agg Forward Aggregate (median) 1-year PD for the US pharmaceutical industry with reference to PDIr2.0 bound. Source: NUS-CRI

In fact, much of the growth in pharma capital raising can be attributed to the need to sustain their portfolio strategy via M&A. Historically, M&A in the US pharmaceutical industry has grown in popularity as pharma companies shift towards building their pipeline through a combination of asset acquisition from biotech firms and internal R&D. In 2019, [more than half](#) of blockbuster drugs⁵ were a result of M&A and in-licensing, rather than in-house R&D, and deal-making in the biopharma industry reached a 5-year high in 2020 with [1138 deals](#), compared to 634 deals completed in 2019. Against the backdrop of increasing regulatory scrutiny, branded pharmaceutical companies in particular have been struggling with [limited headroom](#) to increase prices, relying instead on M&A to achieve the same growth. With borrowing costs still relatively cheap, debt financing could play an increasingly vital role in funding such M&A activity, increasing the proportion of debt-fueled M&A. However, as companies shoulder [increasingly heavy](#) debt burdens to fund their acquisitions, a rebound in M&A could be a credit negative for the industry. We observe that many PDIr2.0 proxied investment-grade companies in the industry have experienced heightened credit risk following their M&A deals⁶. After AbbVie's acquisition of Allergan in May-2020, for instance, AbbVie's PD surged from less than 10bps to reaching the 100bps range over 2 months after the merger took place. Similarly, Bristol-Myers Squibb's acquisition of Celgene in Nov-2019

³ The Dow Jones U.S. Select Sector Specialty Indices measure the performance of specific sub-sectors, or groups of sub-sectors, in the U.S. stock market. Index constituents are float-adjusted market capitalization weighted, subject to capping constraints.

⁴ Financial ratios for the DJUSPR ticker are obtained from Bloomberg.

⁵ A drug that generates more than [USD 1bn](#) in revenue for a pharmaceutical company in a single year.

⁶ This could be because post-merger, leverage of the resultant firm tends to [rise substantially](#). Some existing literature also observes that historically, M&A transactions seem to have a negative [influence](#) on the performance for companies in the US pharma industry. Interestingly, however, M&A had a positive influence on the performance of pharma companies in China, suggesting that the aggregate impact could be economy-dependent.

was accompanied by a steep climb in the company's PD, from less than 1bps to reaching a high of 67bps (See Figure 2a).

In addition, profit growth has been challenging for generic manufacturing and wholesalers as they experienced a substantial [fall](#) in profits between 2016 and 2020. For the companies in our sample, the median EBITDA margin also slumped from -25.80% in 2015 to -71.71% in 2020. Margin pressure for generic manufacturers has been exacerbated by the slowing introduction of new generics and persistent price deflation, with high-cost specialty drugs continuing to increase [the share](#) of total spending, backing the broader trend in the pharmaceutical industry where only [truly innovative](#) products experience better price defensibility. As such, [generic pricing deflation](#) could pose significant headwinds for generic manufacturers such as AmerisourceBergen Corp. Even for branded drugs, pricing pressure is likely to persist throughout the [rest of 2021](#), with net prices expected to be flat or negative. Across the board, the postponement of many elective procedures in H2 2020 also challenged pharmaceuticals' revenues, particularly for medicines that need to be administered in a [clinical setting](#).

Social and governance factors also constitute a material determinant for the industry's credit risk outlook, as US pharmaceutical companies face increasing exposure to regulatory efforts aimed at reforming drug prices and tackling anti-competitive M&A (See supplementary information below). As recent as [Aug-2021](#), the US government called on lawmakers to enact legislation⁷ to put domestic price controls on drugs, especially for a subset of the highest-cost drugs with little competition. These regulatory headwinds could depress profit margins and weaken the US' leadership in the pharmaceutical industry, especially against emerging competitors such as China pharmaceuticals. Correspondingly, the NUS-CRI Forward 1-year Aggregate (median) PD shows that although the US has been recovering from the pandemic since July last year, the credit outlook of the industry has worsened since then, with the Forward PD in Aug-2020 suggesting that PD will rise above the BB- upper bound in the medium-term (See Figure 2b).

Being at the forefront of the battle against COVID-19 could present US pharmaceuticals with the prospect of better [equity capital](#) inflow given the renewed focus on the value of investments in the healthcare industry. However, the industry-wide impact of the pandemic thus far has been multi-faceted: on one hand, pharmaceutical companies have been relatively insulated from the economic fallout of the pandemic, yet on the other, vaccine breakthroughs have [not yet](#) produced substantial profits for the companies developing them. The abundance of capital and liquidity, potential rebound in M&A, and threat of increased regulation by the US Federal Trade Commission (FTC) are likely to be the key factors shaping the credit risk profile of the industry over the medium term. The gradual shift towards increasing leverage in the industry could pose significant downside risk in particular, and looking ahead, prioritizing deleveraging and strong cash flows will be vital in ensuring that companies in the industry are able to meet their medium-term refinancing obligations, with about 33% of its outstanding bonds maturing by 2025⁸.

Supplementary Information

Anti-competition scrutiny from the FTC amid leadership change

Under the leadership of the newly appointed FTC chair Lina Khan, the FTC is likely to push for [tougher regulation](#) in the pharmaceutical industry. Khan's background in legal antitrust research and her tough stance on anti-competition, alongside other factors, has spurred hopes that her appointment could mark a revival in antitrust enforcement. The FTC recently launched a [Task Force](#) to re-evaluate its current approach to reviewing pharma M&A and going forward, and US pharmaceuticals may expect to receive tighter scrutiny on larger M&A deals.

However, it remains to be seen whether the FTC's tougher antitrust agenda will materialize. In the past decade, the FTC has imposed conditions on [less than one-third](#) of M&A activity and has not blocked any mega pharmaceutical deals valued above USD 10bn. With limited resources, the new FTC leadership could also face [temporary limitations](#) in implementing its stricter antitrust agenda. Thus, while the short-term regulatory risk is manageable as companies wait for further action from the FTC, the outlook over a longer time horizon is less certain. Should the FTC start effectively blocking mega-mergers and larger acquisitions, aggregate default risk in the US pharmaceutical industry could rise, as companies are forced to pursue less ideal targets, face revenue headwinds, and increase emphasis on in-house R&D. On the other hand, challenges to mega-mergers may abate the debt boom, and the overall impact on the industry's credit risk profile of the sector depends on the relative strength and interplay of these factors over time.

⁷ This includes by allowing Medicare to [negotiate](#) drug prices and imposing penalties on pharmaceutical companies that hike prices faster than inflation. According to Biden, drug companies could face up to a 95% excise tax if they fail to sell their drugs to distributors at the Medicare price.

⁸ Data obtained from Bloomberg.

Credit News**Investors shun Chinese high-yield debt after Evergrande shock**

Aug 30. The heightened stress in some of China's biggest borrowers has adversely affected investor confidence in the international bond market. Chinese offshore high yield bonds were trading at an interest rate of 13.3%, compared to less than 10% in June. Stress in China's property sector, especially from companies like Evergrande, is contributing to the higher yields as concerns regarding the credit health of the property sector of China continue to weigh on investors' minds. Additionally, Chinese property developers are also experiencing higher borrowing costs in China's onshore credit market, as local governments avoid issuing bonds for new projects amidst pressure to clean up the sector's finances. ([FT](#))

US banks ease loan standards in battle to lend

Aug 30. Due to increased competition for loans fueled by loose monetary policy and the ongoing economic recovery, banks have lowered their lending standards to consumers and small businesses. Loosening of lending criteria has heightened concerns in the bond and loan markets about a credit-standards race to the bottom. With 25% of banks easing lending rules in both consumer and corporate loans to small businesses, it marks the fastest rate of credit loosening ever. Since the onset of Covid-19, fierce rivalry between banks and other lenders to offer new loans has resulted in a massive increase in worldwide debt. Businesses had initially relied on emergency bank credit, which boosted loan growth. However, government and central bank stimulus initiatives sparked a surge in demand from investors to lend to businesses and allowed consumers to pay their debts with their stimulus checks. As a result, consumer loans have declined, and corporate lending has shifted away from banks toward public and private investors. ([FT](#))

Distressed debt funds sparkle in Covid recovery

Aug 25. Distressed debt funds that invest in bonds and loans issued by companies in trouble are having their best year since the financial crisis of 2008-2009. In July, these funds posted their tenth consecutive month of gains, with year-to-date returns of 11.45%. It underlines the quick economic recovery from the pandemic, thanks to massive central bank stimulus and rapid vaccination programs. Furthermore, private equity groups have also utilized the money to support companies they invested in, indirectly assisting the distressed funds. Shareholders' willingness to back their companies has been greater than in the past, possibly because the incumbent distress is perceived to be pandemic-driven rather than due to underlying structural reasons. ([FT](#))

China's municipal yuan debt is going offshore for the first time

Aug 25. The USD 77bn Dim Sum bond market, which is the yuan-denominated offshore Chinese bond market, saw the potential issuance of USD 771mn of local government bonds from Shenzhen. Driven by the US' easy money policies and China's tightening monetary policies, offshore yuan debt sales are looking to peak since 2015. Amidst the surge in onshore municipal bonds sales, the proposed offshore yuan bond offers a potential catalyst to similar issuances in the future, boosting the popularity of the yuan in trade, and further attracting global investors in such securities. ([Bloomberg](#))

Huarong's 2020 loss a record; leverage at 1,333 times

Aug 29. China Huarong Asset Management reported a record loss, and leverage at 1333 times for the delayed 2020 results, with capital buffers far below the regulatory requirements. It posts a loss of CNY 102.9bn last year, with CNY 107.8bn in impairments and a CNY 12.5bn loss on financial assets. This reduced Huarong's equity value by more than 85%. This month, Huarong secured a bailout from several state-owned financial firms, after five months of turbulence since delaying its financial release in March. The company's road to recovery, however, may be bumpy and arduous. The company said that it intends to sell its non-core business divisions soon to generate fund inflows and replenish capital. It also reduced its non-financial local and offshore units from 27 to 13 last year. The company claimed it ensures operations over the next 12 months by implementing asset sales and a capital boost. ([Bloomberg](#))

Sri Lanka bonds set to gain most in Asia as reserve funds sought ([Bloomberg](#))

Indian Bank plans unusual note offering riskier ESG exposure ([Bloomberg](#))

China bonds still under pressure despite PBOC cash injection ([Bloomberg](#))

Regulatory Updates

Emerging economies cannot afford ‘taper tantrum’ redux, says IMF’s Gopinath

Aug 30. IMF Chief Economist Gita Gopinath warned that a taper tantrum in the near term could prove disastrous for emerging markets as they continue to grapple with the coronavirus crisis. Her comments come after Fed Chief Jerome Powell indicated that the US could start tapering its asset purchase program by the end of this year. She warned that as economic activity returns to normal in the US, the rising inflation could prompt the US Fed to tighten monetary policy sooner, adversely affecting emerging markets. The Institute of International Finance reports that average government debt as a percentage of GDP of large emerging economies increased from 52.2 % to 60.5 % in 2020, and more than USD 360bn have flowed into emerging markets in the last nine months alone. This makes emerging markets highly vulnerable to fallout originating from a sudden change in policy by the Fed or other major central banks. ([FT](#))

Bank of Korea hikes rate with debt risk seen bigger than delta

Aug 26. The South Korean central bank increased rates by 0.25 percentage points to 0.75% in its attempt to address the financial imbalances of the rapidly growing household debt. South Korea’s economy has seen a stable recovery amid a surge in Covid-19 delta cases globally, and the government is optimistic that the economy will continue to grow as previously forecasted. However, inflation is expected to grow beyond the current forecast of 2.1% amidst the growing amount of household debt and the surge in home prices. Governor Lee Ju-yeol said that the rate hike hopes to curb demand for new loans, but without proper price expectations and government policies, the increase in rates alone would not slow down the soaring housing prices. ([Bloomberg](#))

China's property crackdown stalks credit markets ([Reuters](#))

India power-sector financier plans first loan using libor heir ([Bloomberg](#))

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