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Credit Implications of Current Events

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With Idenix, Merck Pays High Price for Drugs in Early-Stage Development, a Credit Negative

On Monday, Merck & Co., Inc. (guaranteed obligations A1 stable) said it would buy Idenix Pharmaceuticals Inc. (unrated) for $3.85 billion in cash. The deal is credit negative for Merck because it is paying a premium of more than 200% for a company with no profits and whose pipeline assets for hepatitis-C are still in early-stage development.

Idenix recently completed Phase I trials for its hepatitis-C treatments, which, like many hepatitis regimens now under development, seek to replace interferon injections with pills. In addition to advancing the Idenix compounds to Phase II, Merck plans to test them in combination with its own hepatitis-C pipeline drugs, for which Merck has already presented positive Phase II data.

But even if Merck successfully advances Idenix's compounds through late-stage clinical trials, it will face challenges in the hepatitis-C market, which will become increasingly competitive. Gilead Sciences, Inc. (Baa1 positive) won US Food and Drug Administration approval for its interferon-free regimen for patients with some strains of hepatitis-C late last year. Gilead is also vying with AbbVie Inc. (Baa1 positive) to launch next year the first oral treatment for the most prevalent strain of the disease in the US, known as genotype 1. It is not clear if Merck's products would be differentiated from Gilead's or AbbVie's offerings. Johnson & Johnson (Aaa stable) and Bristol-Myers Squibb Company (A2 negative) are also working on new hepatitis-C treatments, including the recently launched J&J product Olysio, now being studied in various combinations.

Still, the hepatitis-C market is large and growing: the World Health Organization estimates the disease's incidence totals 130-150 million individuals. We estimate that the market will exceed $10 billion in annual sales, based on the large number of people requiring treatment and our expectation that new treatments will cost upward of $80,000 per patient. (Gilead's Sovaldi currently costs $84,000 for a 12-week regimen, but the price could fall if competition increases with newly launched products.) Merck's strategy could ultimately prove successful if Idenix's product is approved and if it demonstrates greater effectiveness than competing products, or is easier to administer; for example, if it is a once-daily, all-oral product for all genotypes of the virus.

We do not expect any long-term debt associated with the transaction, which Merck expects to close in the third quarter of this year. Merck expects the pending sale of its Consumer Products business to Bayer AG (A3 stable) to close during the second half of this year and generate after-tax proceeds of $8-$9 billion. In addition, Merck reported cash, short-term and long-term investments of nearly $32 billion as of 31 March 2014, although a large portion is held by Merck's non-US subsidiaries.

Analog Device's Acquisition of Hittite Is a Credit-Positive Use of Cash

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On Monday, Analog Devices Inc. (A3 stable) announced an agreement to buy Hittite Microwave Corporation (unrated) for $2.5 billion in an all-cash transaction. The purchase is credit positive because it will enhance Analog's capabilities in radio frequency, microwave and millimeter-wave applications for the aerospace, defense, communications and industrial end markets. Moreover, despite the relatively rich purchase price multiple of 15x our estimate of Hittite's EBITDA next year, Analog's use of balance sheet cash to buy assets that produce high profit margins is significantly more favorable to creditors than more share buybacks.

Hittite, with $277 million of revenue and $120 million of EBITDA over the past 12 months, is about 10% the size of Analog's $2.7 billion revenue base. Despite the smaller size, we expect that the combination will slightly boost Analog's already strong profitability (37% EBITDA margins), given Hittite's 44% EBITDA margins and the modest synergies in manufacturing and operating costs that the combined company should easily achieve.

Hittite's product lines complement Analog's capabilities and have no significant overlap. Analog's technology focuses on the radio frequency spectrum between one megahertz and six gigahertz. Hittite primarily targets end markets for higher frequency microwave, between six and 20 gigahertz, and millimeter-wave (20-110 gigahertz) needs such as direct broadcast satellite receivers, military electronic countermeasure systems, automotive collision-avoidance systems and satellite communications systems. Hittite's technology strengths complement Analog's radio frequency and signal conversion expertise in ways that will allow the combined company to create more integrated solutions to better serve the industrial, communications infrastructure and automotive markets.

Net of nearly $500 million of Hittite's cash balances, Analog will fund the transaction with $2 billion of its $4.8 billion of cash and marketable securities. We expect Analog to generate more than $300 million of free cash flow over the next year in addition to more than $50 million generated by Hittite, keeping Analog's liquidity robust. Analog has no debt maturities until April 2016, when a $375 million note matures.

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Activist Carl Icahn Takes Stake in Family Dollar, a Credit Negative

On 6 June, activist investor Carl Icahn announced that he had acquired a 9.4% equity stake in Family Dollar Stores, Inc. (Baa3 stable) in a move aimed at pushing the company to consider strategic changes. We believe Mr. Icahn will press Family Dollar to return value to shareholders, possibly through a debt-financed share repurchase program, debt-financed dividend, or leveraged buyout, which would be credit negative for the company.

Following Mr. Icahn's move, Family Dollar swiftly moved to adopt a poison pill, which would be activated if an investor bought a 10% stake.

Mr. Icahn joins another prominent activist investor in Family Dollar, Nelson Peltz of Trian Fund Management, which already holds a 7.35% stake in the company. Since the expiration of Trian's standstill agreement in 2013, the fund has made no announcement about changing Family Dollar's capital structure or a leveraged buyout (LBO). However, Mr. Icahn's stake raises the possibility that the two activists will join forces in an LBO or force Family Dollar to pursue debt-financed shareholder-friendly moves. Trian currently has one representative on the board of directors, which means it can influence financial policy and operating strategies; at this point, Mr. Icahn's board intentions are unknown.

Family Dollar's weak financial position makes its rating much more susceptible to a downgrade below investment grade if the activists force its hand to use debt to deliver shareholder value. Although Family Dollar has a history of generating same-store sales growth and positive free cash flow, it has had performance problems more recently. Same-store sales growth turned negative starting in the first quarter of this year and free cash flow turned negative in 2013. The company had a modest level of cash flow burn of about $24 million for the 12 months that ended 1 March, while poor operating performance has been pushing leverage levels higher. For example, debt/EBITDA increased to 3.7x as of 1 March from 3.3x as of 31 August 2013.

However, Family Dollar's noteholders have some protections. Family Dollar's $200 million privately placed notes maturing in September 2015 would likely need to be refinanced as part of any potential transaction, given their near-dated maturity. The indenture governing the $300 million senior unsecured notes due 2021 (Family Dollar's only other outstanding debt barring any outstandings under its revolving credit facility) also provides some limited protection against an LBO because it requires Family Dollar to offer to repurchase the notes at 101% upon a "change of control triggering event." This is defined, in part, as the acquisition by any person of more than 50% of Family Dollar voting stock and the notes' ratings lowered by Moody's and Standard & Poor's to below investment grade during a specified period of time before and/or after the transaction. Should Family Dollar ultimately be sold in a leveraging transaction, the company's post-transaction ratings would likely be well below investment grade.

Family Dollar's indentures leave the company more exposed should the activists opt for debt-financed shareholder-value alternatives other than an LBO. The indenture for the $300 million public notes does not protect against other forms of leveraging, such as a debt-financed share repurchase program, or a special dividend.

What Mr. Icahn and Mr. Peltz may do next, and how the indentures may or may not come into play, are unknowns, but Mr. Icahn's new stake clearly indicates that bondholder risks have increased.

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Michelin Plan to Acquire Sascar for €520 Million Is Credit Positive

On Monday, French tire manufacturer Compagnie Générale des Etablissements Michelin (Baa1 stable) announced its plan to acquire Brazil-based digital fleet management company Sascar for €440 million plus assumed debt. The credit-positive acquisition of Sascar, a high-margin business, will enhance Michelin's service offering and allow it to strengthen its fleet management activities in Brazil with specific patents and new tools. The transaction also offers Michelin a good opportunity for a global rollout.

Considering €80 million of net debt assumed, the acquisition values the company at approximately €520 million or 11x expected EBITDA this year. Sascar, which has had 16% revenue growth during the past three years, generated BRL280 million (€91 million) of revenues and BRL104 million (€34 million) of EBITDA with its 870 employees in 2013. Sascar is active in fleet management (74% of revenues), stolen vehicle retrieval (14%) and cargo tracking (12%).

This transaction, which is subject to approval by the Brazilian competition authorities, would mark Michelin's first major acquisition in more than eight years, reflecting the group's cautious approach toward external growth. It would strengthen the group's fleet management activities, a business it has identified as an important growth area for the group.

Given that Michelin will have to assume approximately €80 million of net debt and pay for the remainder of this transaction by using cash on hand without raising additional debt, Michelin's leverage will not materially change from its 2013 2.0x debt/EBITDA level. In terms of profitability, we expect the transaction to be margin accretive given Sascar's solid performance since 2011. Overall, Michelin's credit metrics will be strengthened by investing available liquidity that otherwise would generate only low returns.

Based in Clermont-Ferrand, France, Michelin is one of the three leading tire manufacturers in the world. In 2013, revenues were €20.2 billion. The group offers the full range of tire products, particularly for passenger cars, light trucks and heavy trucks. Other activities include the manufacturing of specialty tires (e.g., for earthmoving and agricultural equipment, motorcycles and aircraft), the distribution of tires and the publication of maps and travel guides.

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MegaFon's $1 Billion Debt Prepayment Is Credit Positive

Last Thursday, MegaFon OJSC (Baa3 negative) stockholders approved a $1.06 billion prepayment of debt to its controlling shareholder, Garsdale Services Investment Ltd (unrated). The debt was created when MegaFon acquired Scartel from Garsdale in October 2013. The transaction will be credit positive for MegaFon because it will reduce the company's gross leverage by up to 0.2x Moody's-adjusted debt/EBITDA, and decrease its foreign currency risk exposure.

The Scartel-related debt will be prepaid with MegaFon's accumulated cash and with proceeds from the placement of a RUB15 billion ($428 million) domestic bond in May (maturing in 2024 with a put option in May 2015). Assuming the debt is prepaid in June, MegaFon's gross leverage will fall to around 1.7x gross debt/EBITDA as of the end of June from 1.9x as of year-end 2013, moving MegaFon closer to the 1.5x level that we consider appropriate for its rating (all metrics are Moody's-adjusted). We would consider a rating downgrade if leverage remained above 1.5x for a prolonged period of time.

In addition, the transaction, which will use a substantial part of MegaFon's significant accumulated cash balance ($1.8 billion as of March 2014) to reduce its debt rather than to pay out dividends, reflects MegaFon's conservative financial policy.

Scartel-related debt is MegaFon's largest single foreign currency denominated liability and would add to MegaFon's leverage if the ruble lost significant value. After repaying the bulk of this liability, MegaFon's foreign currency risk will decline from its already low level. As of March, MegaFon's foreign currency risk was already low because only 20% of its debt (after hedges) was foreign currency denominated.

MegaFon's liquidity will remain strong and refinancing risk low after the debt prepayment. We estimate that its remaining cash, available long-term credit facilities and expected operating cash flow will fully cover its other debt maturities (including the domestic bond put option in May 2015) and its expected capex and dividend payouts over the next 12-18 months.

In October 2013, MegaFon acquired a 100% stake in Scartel/Yota, which at the time owned 2x30 megahertz of nationwide 4G/LTE spectrum in the 2.5-2.6 gigahertz frequency band and a network covering around 30% of the Russian population, for $1.18 billion (excluding debt) to Garsdale. The payment was to have been made in two equal instalments deferred by one and two years, respectively, from the date of the deal closing, plus interest at 6% per year. Garsdale also controls 50% plus 100 shares of MegaFon.

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Japanese Refiners Face Credit-Negative Challenge to Rationalize Oil Refining Capacity

Last Friday, Japan Industry Minister Toshimitsu Motegi warned that the government would penalize the nation's major oil refiners that could not come up with plans to reduce their bloated refining capacity and improve their financial profile. The government has already pushed major refiners to shed capacity over the past five years. To deal with refiners that still have excess capacity, the Ministry of Economy, Trade and Industry (METI) plans to invoke powers under a new industrial competitiveness law to survey the nation's 23 oil refineries, presumably with an aim to identify candidates for consolidation and closure.

METI's announcement is credit negative for Japanese refiners, especially the smaller ones, because some of their refineries will face accelerated consolidation or closure. Although all Japanese refiners will be covered by the government's investigative survey, Cosmo Oil Company, Ltd. (Ba1 negative) and TonenGeneral Sekiyu K.K. (unrated), both of which have the weakest financial profiles among the Japan's top five refiners, are likely to face closer scrutiny than others because they have less flexibility to restructure on their own because their balance sheets are more leveraged than stronger companies (see exhibit).

Cosmo and TonenGeneral Have Weak Financial Profiles

Company Name	Rating	Number of Refineries	Crude Distillation Capacity Thousand BBL*/Day)	Revenue ¥ Billion	Net Asset ¥ Billion	Total Assets ¥ Billion	Ordinary Income ¥ Billion	Ordinary Profit Margin	Net Equity/ Asset
JX Holdings, Inc.	Baa1	8	1,210	12,412	2,626	7,782	302.3	2.4%	33.7%
Idemitsu Kosan Co., Ltd.	Unrated	4	555	5,035	744	2,995	81.9	1.6%	24.8%
Cosmo Oil Company, Ltd	Ba1	3	452	3,538	261	1,697	41.8	1.2%	15.4%
TonenGeneral Sekiyu K.K	Unrated	3	556	3,241	295	1,409	49.8	1.5%	20.9%
Showa Shell Sekiyu K.K	Unrated	3	395	2,954	325	1,296	76.2	2.6%	25.1%

Note: BBL = barrels of oil; Showa Shell's and TonenGeneral's numbers are for the year ended 31 December 2013. The remaining companies' numbers are for the fiscal year ended 31 March 2014.
Source: The companies

The government may find it difficult to demand aggressive capacity reduction from industry players with only three refineries because that would severely compromise their economies of scale. Thus, a likely first step in a government plan for Cosmo and TonenGeneral would involve enhancing the companies' scale through a partial or full consolidation of their refining operations, which would benefit both in the long run and make it easier for the government to impose strict targets on the two companies.

Aggressive capacity reduction to meet the government's demand would shrink refined product sales volume and negatively affect cash flows of both companies. A successful reduction of the industry's excess capacity would gradually improve profitability for all industry players. However, until that occurs, Cosmo must cope with its existing large debt burden (net equity/asset of 15.4%) and downsizing-related restructuring expenses with reduced cash flows under this possible scenario.

The Japanese government is likely to share at least a portion of the refining industry's integration-related expenses to help it become more self sustaining. If the government imposes strict capacity reduction targets, we believe that interim support from the government and key banks will form crucial components of Cosmo's ability to service its debt obligations

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Plant Fire at IRPC Will Reduce Production, a Credit Negative

On Monday, IRPC Public Company Limited (Ba1 negative) vacuum gas oil hydro treating unit (VGOHT), which provides feedstock to a catalytic cracker mainly used for propylene production, caught fire. Although the VGOHT was the only unit damaged, the integrated catalytic cracker has also been shut down. Thailand-based IRPC expects the catalytic cracker to remain shut down this month, after which it will operate at a utilisation rate of at least 60% until the VGOHT is repaired in September.

This shutdown of the catalytic cracker is credit negative because it will materially reduce propylene volumes, and diesel and gasoline volumes, although to a smaller extent. These lower production volumes will reduce IRPC's earnings.

Assuming that full operations resume in October, we expect that the shutdown will reduce the company's gross integrated margin by $0.80-$1.00 per barrel this year. This will translate to a 10%-15% decline in EBITDA. IRPC's operating margins and profitability, which have been under pressure over the past two years, will remain weak, with EBIT/adjusted debt under 1x.

The expected earnings decline is largely attributable to lower propylene volumes. The catalytic cracker produces about 30% of IRPC's total propylene capacity of 412,000 metric tonnes per annum (MTPA). Propylene is used as a feedstock to produce polypropylene, one of IRPC's key petrochemical products. If IRPC fails to procure a propylene replacement from the market, output at the 475,000 MTPA polypropylene plant will fall accordingly. As a result of the shutdown, IRPC will also lose 1.3 million litres of diesel and gasoline.

Although IRPC is still appraising the total cost to resume full production, we expect that the company's insurance coverage of up to $1.2 billion will prove sufficient.

At the same time, there is no immediate ratings effect because IRPC's Ba1 ratings and negative outlook already reflect the pressure we expected on its financial profile and credit metrics over the next 12 months. The company since 2011 has been undertaking a large capital-intensive expansion project called the Phoenix Project to increase its output capacity for higher-margin petroleum and petrochemical products. It has planned capex of $1.4 billion for 2014-18, of which $802 million will be spent this year.

There are currently no indications that the disruption in propylene production will delay the execution of the Phoenix Project. We continue to expect IRPC's operating performance to materially improve in 2015 when its key petrochemical project is completed. If the cracker shutdown materially delays the Phoenix Project, it would be credit negative for IRPC and may result in a ratings downgrade.

IRPC is the second-largest oil refinery and third-largest petrochemicals producer in Thailand. It is one of six domestic oil refiners and suppliers of petroleum products with a refining nameplate capacity of 215,000 barrels per day.

Sub-sovereigns

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Zagrebacki Holding's Planned Demerger of Five Business Entities Is Credit Positive

On 5 June, Croatia's Zagrebacki Holding D.O.O. (Ba2 negative) said it had adopted a plan to split off five branch entities it owns – Zagrebacki Elektricni Tramvaj (ZET, public transport company), Zagrebacki Velesajam (trade fair), Robni Terminal Zagreb (warehousing), Vladimir Nazor (travel agency) and Veletrznice (wholesale and retail markets) – into new limited liability companies.

The demerger is credit positive for the government-related industrial company because it will eliminate the financial pressure stemming from its biggest loss-making branches, ZET and Zagrebacki Velesajam. Both units' financial performance has been weak, recording an aggregated loss of HRK89 million in 2013. We expect the demerger to be completed in the second half of this year.

The demerger is part of the company's restructuring, which aims to divide shared services and market operations. It will allow Zagrebacki Holding to focus its resources on the remaining 10 core entities within the holding company and provide additional cash for debt repayment and investment. The City of Zagreb, as an owner of all new companies, will have control over the management and companies' operations and will continue to provide timely and sufficient support to ZET in the form of operating and capital subsidies. Should the plan be approved by the Zagrebacki Holding's Assembly, which includes Zagreb's mayor, deputy mayor and finance department head, we expect a positive effect on Zagrebacki Holding's debt metrics.

We estimate that EBITDA will increase by 30% in 2014 to a little more than HRK1.0 billion, which would help the company stabilize its cash flow and earn an operating profit for the second consecutive year after three years of losses. We also expect its debt burden to decline significantly to HRK3.9 billion from HRK6.4 billion in 2013, given ZET's debt constitutes a large share of Zagrebacki Holding's overall indebtedness. We estimate the debt/EBITDA ratio would decline to roughly 4.2x this year from 7.6x in 2013, while its debt/operating-revenue ratio would decrease to below 90% from 116%. In addition, the restructuring includes a sale of non-core assets in Savudrija and Duga Uvala, with the proceeds dedicated to further debt reduction.

Following the demerger, Zagrebacki Holding will benefit from a straightforward reduction of cross-subsidized financial support that it has provided to branch entities in the past, which will result in additional cost savings. The financial support the company provided in 2013 totaled HRK110 million, which, after the demerger, it can use to improve its liquidity position.

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