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Teva Pharmaceutical Industries Ltd (TEVA)

Assessing the market technicals behind a potential downgrade to high yield

Barclays Rating: Underweight
Moody's/S&P/Fitch Rating: Baa3 (Negative) / BBB (Negative) / BBB- (Negative)

Note: This publication serves as a follow on to our recent downgrade report (When the music stops…, August 7, 2017).

Executive summary

Over the past few days, news pertaining to levers this company could pull to retain its investment grade status has picked up. Based on our conversations with the rating agencies, we conclude that while still within the realm of possibility, the likelihood of a downgrade occurring in 2017 is fairly slim. However, we still see significant risk of one or more negative rating actions in 2018. If that were to occur, we estimate that the market could see at least $2.5bn of gross forced selling in the USD bonds from investment grade benchmarked investors and insurance money. With no natural incremental buyers stepping in post-downgrade – TEVA bonds will not be eligible for inclusion in US high yield indices and are already included in ratings agnostic EM indices – we think there could be meaningful pressure on spreads. These technical headwinds further reinforce our Underweight rating on the basis that we still see risk to be asymmetrically skewed to the downside.

That said, given the longer-term nature of our view, we believe investors could generate Alpha by trading the range until the company's announcement of full-year results. For TEVA 2026s (the most liquid bond in the capital structure), we view the appropriate range to be 175-250bp (OAS); if bonds begin to leak wider and approach the high end of this range, we think investors could add risk to capitalize on short-term reactions to positive headlines around incremental asset sales and potential equity raises. On the flip side, if spreads begin to price in too much credit for headlines alone and bonds begin to converge with MYL, we would recommend selling the news.

Updated thoughts on evolving developments

TEVA bonds appear to have found a clearing level

It appears that TEVA bonds finally found a clearing level during Tuesday's trading session. At current valuations, and based on our conversations with clients, the market seems to be assessing the likelihood that this company ultimately gives up one or more of its investment grade ratings. Our discussions with investors indicate that focus has shifted from whether this company will be able to resist a downgrade to whether management would defend the investment grade ratings even if that would come at the expense of shareholders.

In our view, the shift in investors concern reflects a general acknowledgment that should management choose to defend the investment grade ratings, the company could resort to some sort of capital raise. Aside from simply issuing common equity, the market has also been assessing the possibility of a capital injection from foreign funds after an Israeli newspaper first reported potential interest ("Foreign Funds Mull Buying Controlling Share of Teva: TheMarker", *Bloomberg*, August 7, 2017).

With the stock now down nearly 45% since 2Q earnings on Thursday, our thoughts are that a decision to pursue any type of equity raise would need to go hand-in-hand with an explicit intent to hold at Baa3/BBB/BBB-. At this juncture, and especially in light of the fact that the company remains without a CEO at the helm, we believe the interim management team is somewhat struggling to balance interests on both sides of the capital structure (eg, reducing the dividend by 75% versus suspending it altogether); as such, we are not yet convinced that Teva would be willing to commit to such a dilutive transaction.

A refreshed view from the agency

Late Monday night, Moody's published an updated credit opinion following its downgrade to Baa3/Negative on August 3. Our sense is that the agency intends to give this company time to stabilize its operations. That said, Moody's indicated that another guidance cut or difficulty monetizing assets to help offset deficient organic cash flow could result in a more expeditious downgrade. In our view, the longer Teva goes without a CEO, the more difficult it will inevitably become to get comfortable with its strategic direction in the middle of recovery. Moody's continues to cite ongoing pressure in the US generics business such that growth is not expected beyond 2018 as a key factor that could lead to a downgrade. Again, we take note that this specific parameter stands in stark contrast with what Teva disclosed in its Form 6-K – specifically, "Teva expects revenue and operating profits [in its U.S. generics reporting unit] to continue to decline in the next two years, as its ability to successfully launch new generic products is not expected to offset or exceed the price and volume erosion for its existing portfolio prior to 2020." All said, we think the risk to Moody's Baa3 rests more heavily in the company's ability to achieve its reset guidance and continue to divest non-core pockets of business than in its leverage calculation alone.

A marginally positive concession from Mylan

In conjunction with Mylan's 2Q earnings on August 9, the company announced that "out of an abundance of caution" expectations for a launch of generic Copaxone have been deferred to 2018. Recall that Mylan had previously guided investors to target action dates for both its 20mg and 40mg applications in June; however, halfway through the month, management disclosed that it had received an information request for its 20mg ANDA, which would delay potential approval by an unspecified amount of time. During its earnings call, Mylan alluded to a new target action date in mid-September, but refrained from suggesting a favorable decision would be announced then. We view the concession to be marginally positive for Teva, but believe the market was already expecting this product to get pushed into 2018. Additionally, uncertainty related to the timing of Momenta/Sandoz's Glatopa 40mg application remains outstanding and subject to remediation of Pfizer's warning letter.

Index eligibility rules could lead to at least $2.5bn of TEVA USD bonds left without natural buyers

Index implications – not the normal fallen angel path

As a follow-up to our initial relative value framework, we highlight key market technicals that should be considered when evaluating the potential spread widening that could occur if Teva were to lose two of its three investment grade ratings. While appreciating that many market participants continue to foresee this company remaining at Baa3/BBB/BBB-, we think it is important to properly assess how bonds might trade in a downside scenario. Specifically, if the credit were to fall out of the Bloomberg Barclays Global and US Agg indices, they would **not** simply cross over into the Bloomberg Barclays US HY index as the latter excludes EM issuers and Israel is considered an emerging market under the specified restrictions. This would imply that bonds subject to forced selling by funds benchmarked to the Bloomberg Barclays Global and US Agg indices would not be met by a natural incremental buyer base. TEVA bonds are already included within the Bloomberg Barclays EM Hard Currency index and, thus, there would be no effect from the pool of money benchmarked against it.

We estimate at least $2.5bn of forced selling if TEVA were to lose its investment grade status

Our analysis concludes the following: 1) assuming that $1-2tn is benchmarked against the Bloomberg Barclays Global Agg index; 2) Global Agg portfolio managers have a Market Weight exposure to TEVA; and 3) Global Agg portfolio managers would be forced sellers in the event of a downgrade to high yield, we would expect a potential $750mn of gross forced selling from these funds, of which $500mn would be USD bonds.

Similarly, 1) assuming that $2-3tn is benchmarked against the Bloomberg Barclays US Agg index; 2) US Agg portfolio managers have a Market Weight exposure to TEVA; and 3) US Agg portfolio managers would be forced sellers in the event of a downgrade to high yield, we would expect up to $2bn of forced selling from these funds.

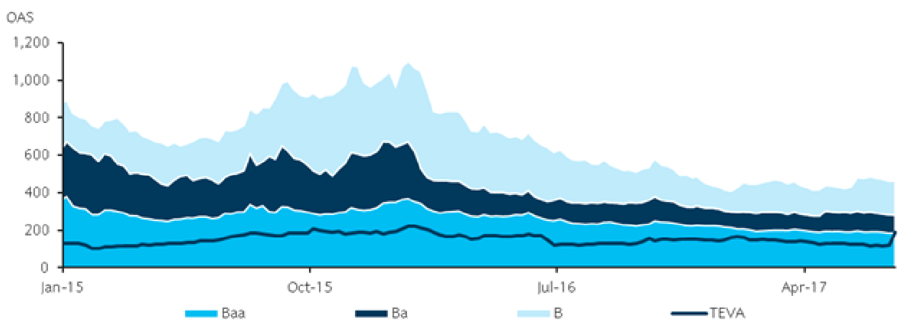
In addition to the initial forced selling from benchmarked investors, we would also expect insurance money (a large source of buyers within the US investment grade credit market), to reduce their exposure to the name. Unlike the investment funds that generally have to sell their holdings within two months following a downgrade, insurance companies are able to gradually reduce exposure over a longer period. However, given the lack of transparency into insurance holdings, we cannot accurately estimate the amount of bonds that could be sold in the aftermath of a potential downgrade.

Although TEVA EUR bonds are also included in the Bloomberg Barclays EUR Agg index and thus would similarly be subject to some degree of forced selling, we do not have estimates for the amount of assets under management that is benchmarked against it; as such, we are unable to estimate the magnitude of effect from forced selling that could occur following a downgrade to high yield on TEVA EUR bonds.

Thus, we estimate that a downgrade by two of the three agencies could trigger at least $2.5bn of forced selling in TEVA USD bonds across funds benchmarked to the Bloomberg Barclays Global and US Agg indices.

As a result, in the event that Teva were to lose its investment grade status, we think bonds could actually widen to where other BB-rated EM credits trade. At current valuations, TEVA bonds are trading exactly in line with BBB EM credits which implies that on an adjusted basis (ie, after accounting for the loss of a natural buyer base) the market is actually not adequately pricing in the risk of downgrade. Current levels suggest that credit investors should be getting paid an incremental 92bp in spread for owning BB versus BBB EM paper.

TEVA versus EM Credits (OAS, bp)



Source: Bloomberg Barclays Indices, Barclays Research

Quick facts on the composition of various benchmark indices

- **Bloomberg Barclays Global Agg**: TEVA USD, EUR, and CHF bonds are included. In aggregate, the issuer's bonds account for 0.05% of the index, with 0.03% attributable to its USD bonds. This index is ratings sensitive and requires bonds to have an investment grade rating (median).

- **Bloomberg Barclays US Agg***:* Due to their SEC registration, TEVA USD bonds are included. The issuer's bonds account for 0.08% of the index. This index is ratings sensitive and requires bonds to have an investment grade rating (median).

- **Bloomberg Barclays EUR Agg**: TEVA EUR bonds are included and account for 0.06% of the index. This index is ratings sensitive and requires bonds to have an investment grade rating (median).

- **Bloomberg Barclays EM Hard Currency Agg**: Given its country of risk (ie, Israel), TEVA bonds are included and account for 1.2% of the index. They are also included in the JPMorgan CEMBI index. Neither of these indices are ratings sensitive.

How many notches of downgrade are required for index exclusion?

- TEVA bonds are rated by three rating agencies. Based on the index rating methodology (ie, using the median rating), an issuer would be excluded from investment grade indices if at least two of its three ratings are below investment grade. Thus, TEVA bonds require at least two non-investment grade ratings to be excluded from the Bloomberg Barclays investment grade indices. Other benchmark indices use the average rating in which case the notches of downgrade matter.

Assuming a downgrade, would TEVA bonds be included in the high yield indices?

- **USD HY indices**: Most of the widely followed US HY indices exclude all EM issuers. An EM issuer is defined by its country of risk. Bloomberg Barclays indices consider Israel to be an emerging market.

- **EUR HY indices**: Like the USD index, the Bloomberg Barclays Pan EUR HY index excludes all EM issuers. However, a competitor's EUR HY index does not place restrictions on an issuer's country of risk. Thus, TEVA EUR bonds would likely be included in this specific index following a downgrade, which could provide some support relative to USD bonds.

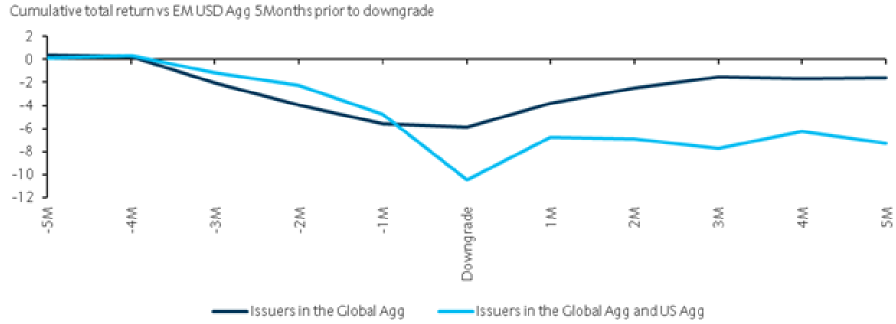
What are lessons learned from previous fallen angel EM issuers?

- With at least $2.5bn of forced selling and no natural incremental buyers (given that TEVA is already included in the ratings agnostic EM indices), we believe that spreads could come under additional pressure in the event of a downgrade. In previous fallen angel scenarios, the underperformance relative to EM peers reached 5% into the downgrade, with SEC registered names included in the US Agg underperforming by up to 10% during the month of downgrade (eg, PETBRA, BRAZIL, TURKEY).

- In the case of TEVA, while we expect the name to underperform, the degree of underperformance would depend on the capacity of US and Global Agg fund managers to keep exposure to the name despite the downgrade and the appetite of US HY managers to add off-benchmark exposure.

For more details of how previous fallen angel EM issuers have traded, please see Trading EM 'falling angels': History does not repeat itself but it rhymes, February 19, 2016.

Fallen angels underperform into the downgrade but outperform thereafter



Note: Cumulative total return performance of fallen angels versus the Barclays EM USD Agg index beginning five months prior to index exclusion. Sample of issuers since 2009: 42 fallen angel issuers in the Global Agg index and five issuers in the U.S. and Global Agg indices. Source: Barclays Research

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Primary Issuers/Bonds
TEVA PHARMACEUTICAL FINANCE CO BV, Underweight, CD/D/J/K/L/M
Valuation Methodology: Our Underweight rating reflects a 2Q release that exposed the severity of the company's deep-seated issues. Management's posture during the earnings call was in stark contrast with prior commentary – specifically, upside to previously articulated asset sales, new product launches, and debt reduction targets for 2017 now appear unachievable. Further, despite another significant rebasing of Teva's full-year outlook, we continue to see execution risk, particularly to management's guidance for cash flow from operations and the reiterated goal to repay $5bn of debt by year-end.
Risks that May Impede Achievement of the Rating: We think downside to our Underweight rating is that in a best-case scenario, the bonds grind back to flat versus MYL over time driven by any number of the following: 1) generic Copaxone is delayed beyond early 2018 such that the franchise continues to support and somewhat offset continued deterioration in the US generics business; 2) management's forecast for accelerated pricing erosion proves too punitive; 3) recent product delays are resolved more quickly than currently anticipated, enabling the company to overcome the intensifying competitive landscape; 4) future asset sales materialize more quickly than the ongoing processes have taken thus far this year or a decision is made to sell a much larger piece of the business and use proceeds to repay debt; or 5) management confirms long-standing reports that the company has been seeking to issue euro debt to refinance dollar debt and tenders for bonds.
Representative Bond: TEVA 2.95 12/18/22 (USD 95.99, 09-Aug-2017)
Representative Bond: TEVA 3.65 11/10/2021 (USD 100.36, 09-Aug-2017)

Materially Mentioned Issuers/Bonds
TEVA PHARMACEUTICAL FINANCE NETHERLANDS III BV, CD/D/J/K/L/M
TEVA 3.15 10/01/26 (USD 91.24, 09-Aug-2017)

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High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to exceed the six-month total return of the relevant index.

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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Underweight (UW): The analyst expects the six-month total return of the rated debt security subject to this rating to be less than the six-month expected total return of the relevant sector.
Rating Suspended (RS): The rating has been suspended temporarily due to market events that make coverage impracticable or to comply with applicable regulations and/or firm policies in certain circumstances including where the Investment Bank of Barclays Bank PLC is acting in an advisory capacity in a merger or strategic transaction involving the company.
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Overweight (OW): The analyst expects the six-month total returns of the issuer's rand-denominated fixed rate notes or floating rate notes (as applicable) to exceed the six-month expected total returns the South African Credit Fixed Market Index (CFIX95) or the South African Credit Floating Market Index

(CFL020), respectively.
Market Weight (MW): The analyst expects the six-month total returns of the issuer's rand-denominated fixed rate notes or floating rate notes (as applicable) to be in line with the six-month expected total returns the South African Credit Fixed Market Index (CFIX95) or the South African Credit Floating Market Index (CFL020), respectively.
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The analyst expects the three-month excess return of the country's index eligible bonds to exceed the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.

Market Weight (MW):

The analyst expects the three-month excess return of the country's index eligible bonds to be in line with the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.

Underweight (UW):

The analyst expects the three-month excess return of the country's index eligible bonds to be less than the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.

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