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Rx for income

Fabiano Santin writes:

Investors are hoping that the immense tort trial set to begin Monday in the U.S. District Court for the Northern District of Ohio will prove as short-lived as it is consequential. Opioid MDL is the name of the proceeding. The initials signify "multidistrict litigation," which indicate, in this instance, the collapse of some 2,600 lawsuits into one. Plaintiffs contend that the criminal marketing and distribution of opioids has caused an unspeakable trail of human misery with commensurate costs to law enforcement, public health, individuals and families. The aggrieved parties seek billions.

Among the many defendants uneasily awaiting their day in court is the world's largest generic-drug manufacturer, 118-year-old Teva Pharmaceutical Industries Ltd. (TEVA on the Big Board), whose shares have plunged by 90% since reaching an all-time high of $72 on July 27, 2015. That was the day Teva unveiled its ill-fated $40.5 billion acquisition of the generics business of Allergan plc.

Now in progress is an analysis of the risks and opportunities on offer in Teva's capital structure. A short list of perils, quite apart from the looming trial, would include a leveraged balance sheet, softening generic-drug prices and an antitrust complaint filed on May 10 by attorneys general of 44 states alleging that Teva, among 19 other generics manufacturers, colluded to raise prices on more than 100 drugs. Also casting shade is the patent break on Copaxone, Teva's leading branded drug that represented 12% of 2018 revenues and an even larger share of profits.

Partially offsetting such troubles is strong free cash flow, the potential for a quick resolution of Opioid MDL and significant asset coverage based not only on the current drug portfolio but also on a strong product pipeline. We have no conviction on Teva's equity—there are too many moving parts in the story—but we are bullish on its senior unsecured bonds that already trade with several-notch downgrades implied from their current double-B ratings (with a negative outlook by both Moody's and S&P). Assuming the removal of existential corporate threats—and there can be no guarantees, of course—the bonds offer the potential for double-digit returns.

Although Teva is mostly known for its generics division, branded products are relevant to the top and bottom lines. In the first half of 2019, Teva's revenues slumped to $8.6 billion from $9.7 billion. The widely expected drop was mostly owing to the aforementioned Copaxone, a best-selling drug for treating multiple sclerosis. Its U.S. sales fell to $260 million in the second quarter, from $842 million in the like period of 2017. Nor was this decline unexpected given the Food and Drug Administration's green light to generic competition two years ago. The strengthening U.S. dollar exchange rate has taken its toll on non-American sales, which represent about half of Teva's total revenues and make a meaningful contribution to net income.

Adjusted earnings before interest, taxes, depreciation and amortization slipped to $1.1 billion in the six months

Teva Pharmaceutical Industries Ltd.
in $ millions

	2014	2015	2016	2017	2018	TTM*
revenue	$20,272	$19,652	$21,903	$22,385	$18,854	$17,720
adjusted Ebitda	6,262	6,621	7,371	6,665	5,319	4,643
net interest expense	300	270	546	875	920	876
net income	3,055	1,588	329	-16,265	-2,150	-3,888
cash from operations	5,127	5,542	5,225	3,507	4,181	2,184
capital expenditures	-929	-772	-901	-874	-651	-589
free cash flow	4,198	4,770	4,324	2,633	3,530	1,595
shares repurchased	-500	-439	0	0	0	0
share issuance	0	3,291	329	0	0	0
dividends	-1,156	-1,155	-1,558	-1,161	-22	-52
net acquisitions	-167	-2,785	-34,146	3,520	890	238
total debt	10,284	9,957	35,798	32,473	28,907	29,281
cash and cash equivalents	2,226	6,946	988	963	1,782	2,165

* For the period ended June 30, 2019.
sources: company reports, the Bloomberg

till June 30, from $1.4 billion a year before. Compensating in part for Copaxone's patent-related knee-capping were such economy measures as the closing or divestiture of some 20 factories and thousands of layoffs worldwide.

In the first six months, Teva's bottom line registered a net loss of $768 million (vs. a $968 million profit in the corresponding 2018 period), driven by $1.9 billion in charges from impairments to intangible assets, legal provisions related to ongoing opioid litigation, restructuring and other contingencies.

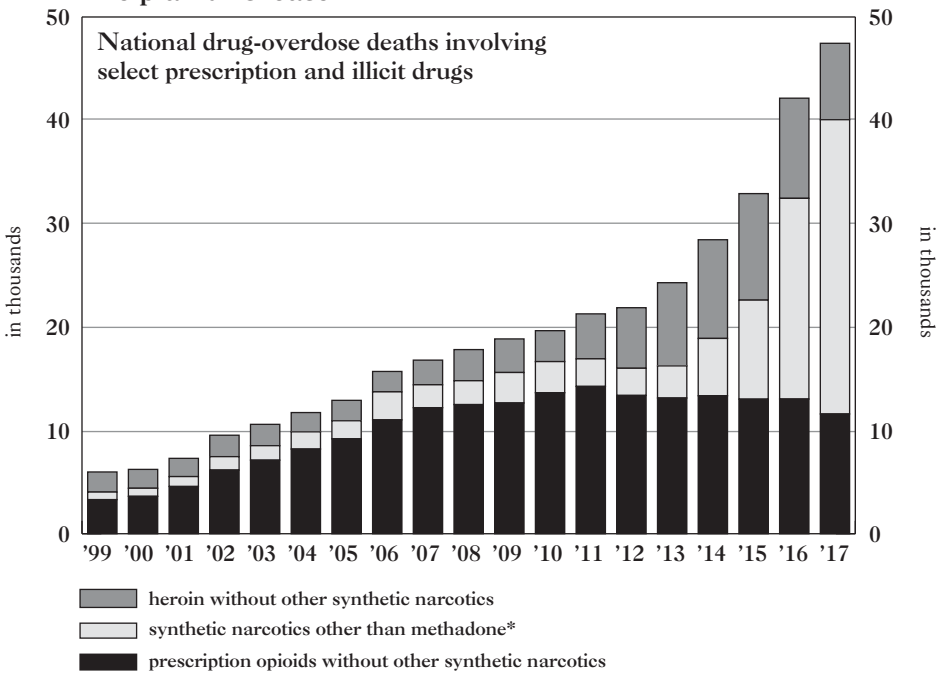
Teva showed net midyear borrowings of $26.5 billion, or 5.7 times trailing adjusted Ebitda of $4.6 billion. In the corporate back pocket on June 30 was $1.8 billion yet undrawn from a bank-credit facility. Interest coverage from operating income stands at a healthy 5.1 times interest expense.

If buying Allergan's opioid-manufacturing activities weren't an unforced error of sufficient size and gravity, former Teva managers compounded it by neglecting to take advantage of record-low interest rates to stretch out the company's debt profile. Some $2.6 billion bonds mature in 2020, and another $4.2 billion the following year. As the sum of available cash, credit and expected cash generation falls short of what will be needed to meet those claims, Teva must return to the debt markets. At least the blundering managers have left to pursue other opportunities. A new executive team led by CEO Kåre Schultz, a well-reputed 58-year-old pharma-industry veteran, seems to know what it's doing.

But Mr. Market may ask for more. The skeptical gentleman will likely withhold his blessing on the Teva value proposition until the risk of a devastating loss in the opioid litigation has passed. Nor do recent jury verdicts—including an $8 billion judgment against Johnson & Johnson last week for producing the antipsychotic drug that supposedly caused the male plaintiff to grow enlarged breasts—foster airy optimism. The complexity and menace of the opioid case turns off prospective investors before they give it much thought.

According to the National Center for Health Statistics, opioids killed 400,000 Americans between 1999 and 2017; 24% of the toll is attributed to prescribed painkillers, the balance to illicit drugs such as heroin and synthetics like fentanyl, sometimes mixed with medication. Cities and states, burdened by fiscal deficits and underfunded pensions, needed no prodding to file suit against profitable drug makers, distributors and retailers in federal and state courts nationwide.

The plaintiffs' case



* This category is dominated by fentanyl-related overdoses.
Source: National Center on Health Statistics, CDC WONDER

Each lawsuit is slightly different, focused on this or that supposed misdeed of one defendant or another, the allegations often tailored to the scope and peculiarities of state laws. There have been many settlements along the way, including Teva's June agreement to pay $85 million to the state of Oklahoma even while denying any wrongdoing.

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Teva, headquartered in Petah Tikva, Israel, is one of three drug manufacturers still facing trial (though in substance, if not in law, it's all alone, having acquired both of the others: Cephalon, Inc. in 2011 and Actavis LLC in 2016). On Oct. 11, attorneys for the three moved that the manufacturers be given a separate trial, lest a jury confuse their culpability with that of the big distributors.

While the MDL case centralizes discovery and pretrial motions for lawsuits by those 2,600 plaintiffs—cities and counties, individuals, hospitals, Native American tribes, third-party payors, the state of Alabama—only two, the Ohio counties of Summit and Cuyahoga, will appear before Judge Dan A. Polster as avatars, or bellwethers, for the others. The remaining 2,598 parties could still decide to sue in each of their respective jurisdictions, though the procedural incentives in place—so it is thought, and so investors may hope—will discourage it. (The discovery and pretrial motions that Judge Polster has executed will not be repeated in any case.)

Judge Polster wants a major settlement—he's made that clear since the opening hearing in January 2018. In fact, he has already given his preliminary verdict: "In my humble opinion, everyone shares some of the responsibility, and no one has done enough to abate it." He so said in urging an agreement to deal with the future supply of opioids as well as with the formula for a monetary settlement.

Blamed for starting it all, closely held Purdue Pharma L.P., which introduced the breakthrough chronic-pain drug OxyContin in 1995, reached a settlement of more than $10 billion with the MDL plaintiffs and 23 states and filed for Chapter 11 bankruptcy protection on Sept. 15. Purdue will be restructured as a public beneficiary trust, with the Sackler family agreeing to inject up to $4.5 billion into the business they no longer own. The shamed defendant likewise pledged to donate drugs worth

more than $4 billion to cities, counties and states, as well as future profits from pharmaceutical sales, including those deriving from OxyContin.

That the plaintiffs accepted such a big share of their settlement in the form of in-kind drugs raises the hopeful possibility (i.e., the creditors' hope) that $10 billion may prove a kind of ceiling. It would not be unreasonable, the argument goes, since unbranded drugs, like the ones Teva chiefly, though not exclusively, sells, are cheaper and less notorious than branded ones (because, for one thing, federal law prohibits their manufacturers from advertising them). Thus, the ill-gotten opioid gains reaped by a generic maker are smaller than the ones that Purdue raked in with OxyContin.

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In an Oct. 2 commentary, Moody's contends that, based on Judge Polster's recent rulings, including his order to certify a "negotiating class," plaintiffs and "some defendants" may reach "comprehensive settlements" by the end of this year or early in 2020. The judge's novel procedural ground rules furnish the plaintiffs with strong incentives to remain in the negotiating class or risk costly and uncertain trials and appeals by going it alone.

Though Teva is a cash-flow machine, it's a highly leveraged one, and a self-interested plaintiff might think twice before making demands that would throw the golden goose into bankruptcy. State attorneys general, too, mindful of that encumbered balance sheet, may strive to achieve a workable solution—as they did with Purdue, which had neither the publicly traded securities nor the financial wherewithal with which to remain solvent.

Based on the recent settlement of Mallinckrodt plc and Endo International plc with the two Ohio counties, CreditSights reckoned last month, Teva would owe $4.8 billion. Assuming the sum were payable on an installment plan, say, over 10 to 30 years, the author-analysts judge that the blow would prove "manageable."

Indeed, Teva expects to generate anywhere from $1.6 to $2 billion in free cash flow this year, and about $2 billion in subsequent years, which would more than cover annual payments of $240 million, if that projected hypothetical $4.8 billion were spread over 20 years.

On an Oct. 2 webinar, Eric Axon, a CreditSights senior analyst and head of its U.S. high-yield research, discounted the odds of a Teva bankruptcy—it would be "far from [his] base case," he said when asked to comment on the potential recovery in bankruptcy on the company's senior unsecured notes. The assumption of a $5 billion run-rate of adjusted Ebitda and an enterprise multiple of seven to eight times gets you to a $35 billion to $40 billion enterprise value, which, as Axon says, would afford an ample margin of safety to cushion net debt of roughly $26 billion. So bankruptcy recovery would be less than par only if legal liabilities rose above $9 billion, or nearly twice the amount that recent settlements suggest—and "suggest" is certainly the word, the future being a closed book in any case but especially so in such a thicket of contingencies as those that face the contestants in Judge Poster's courtroom.

Since February, CEO Schultz has been saying that this year will prove to be Teva's trough, and so far it appears as though it might be. Thus, comparing the second quarter with the first, revenues were slightly up and Ebitda was essentially flat. Meager free cash flow, just $528 million in the year to date, can be attributed to working-capital movements and the timing of bonus payments; $1 billion of free cash flow is said to be on tap for the second half.

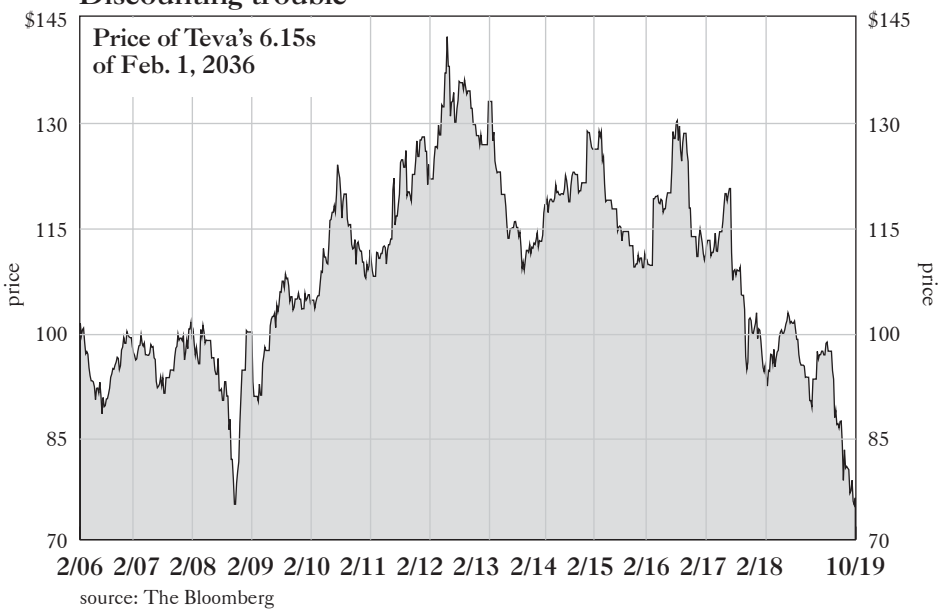
For a growth engine, Teva is counting on Austedo. It's a drug to treat movement disorders such as tardive dyskinesia and Huntington's disease; U.S. patents don't begin to expire till 2031, European ones not till 2029. Sales of Austedo reached $96 million in the second quarter, from $44 million in the like period of 2018 and just about zero in the year before that.

Teva's American generic-products pipeline is a busy one. At the end of last year, the FDA was scrutinizing 297 applications for approval, representing sales of branded products exceeding $114 billion, according to the 2018 10-K. Generic manufacturers often try to jump the gun on the 20-year exclusivity period of patent protection. First-to-file patent challenges, which, if approved, come with the prize of a 180-day exclusivity period, collectively amounted to $74 billion in U.S. brand sales, highlighting large opportunities.

Teva's new brooms have set themselves the goal of reducing net debt to less than three times adjusted Ebitda in the next three to five years, down from 5.7 times currently, and of lifting operating margins to 27%, from 23%. "We will continue to use all our cash flows to really pay down debt," Schultz told dialers-in during the second-quarter earnings call. "We think that's the best way to create value for our long-term shareholders."

Which brings us to Teva's double-B-rated 6.75s of 2028 ($1.2 billion outstanding). The bonds change hands at 84 1/8 for a 9.5% yield to maturity, or 787 basis points over Treasurys, down from 103 in May before the price-fixing allegations hit the tape. Issued in April 2018, after the opioid litigation be-

Discounting trouble



source: The Bloomberg

came front-page news, they are Teva's highest-coupon securities.

You get a sense of Teva's currently low estate by, first, observing that that 787 basis-point spread is not so far from the average 930 basis-point spread at which triple-C rated borrowers—We Cos. is one—are marked. It's a long way from single-B territory (400 basis points), let alone double-B (220 basis points). At the standard single-B spread, the bonds would be quoted in the neighborhood of 107, 27% higher than the current level. A speculator—and we are talking here about speculation—can dream.

Alternatively, one may consider the Teva 6.15s of 2036 ($790 million outstanding), which trade at 76 for a 9% yield to maturity, or 720 basis points over Treasurys. Originally issued in 2006 as 30-year securities, the 6.15s bottomed at 75 in September, the same price they fetched at the October 2008 Lehman nadir. The bonds transacted above par about a year ago and at 130 just three years ago. If they were valued at 500 basis points over Treasurys, they would be higher in price by 27%.

Over the past 12 months, insiders have spent $1.1 million on purchases of the common shares they presumably know something about, though that doesn't paint a full picture of C-suite investment sentiment. Through the end of May, officers and directors had sold $863,000 worth of shares, mostly at prices higher than $16. But in June, Chairman Sol J. Barer, an independent director who holds a Ph.D. in organic and physical chemistry, laid out $2 million for shares then trading at $9.30 vs. the current price of $6.50.

As to the equity sell-side analysts, five say buy, five say sell and 18 mumble hold. CreditSights, as noted, assigns an "outperform" rating to Teva bonds, favoring the 2028 and the 2036 notes. That judgment puts it in the good company of Carol Levenson, director of research and co-founder of GimmeCredit, who—with respect to the 2028 notes alone—likewise says "outperform."

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