Sanofi
France, Pharmaceuticals

SCOPE AA STABLE

Corporate profile

Sanofi is one of the largest pharmaceutical companies with a global footprint. The group is a provider of healthcare products, focusing on innovative medicines. Other activities include vaccines and over-the-counter (OTC) products; the animal health business was divested and the European generics business was sold at the end of 2018. Sanofi was formed in 2004 through the merger of Sanofi Synthelabo and Aventis (including Hoechst of Germany). In 2011, Sanofi acquired US-based Genzyme Corp. for about USD 18bn in a bid to build a leading, global rare-disease platform. In H1 2018 two innovative speciality care companies, Ablynx and Bioverativ, were acquired for a total of EUR 13bn.

Key metrics

			Scope estimates	
Scope credit ratios	2017	2018	2019F	2020F
Scope-adjusted debt (SaD)/EBITDA (x)	0.8	2.3	1.7	1.3
Scope-adjusted FFO/SaD (%)	94	32	46	62
Free operating cash flow (FOCF)/SaD (%)	70	17	37	52

Rating rationale

Scope Ratings affirms its AA issuer rating on French pharmaceutical group Sanofi. The short-term rating is S-1+. The senior unsecured debt rating is AA and the rating Outlook is Stable.

The affirmation mainly reflects our view that the strong improvements in operating trends and cash generation in H1 2019 will extend into the second half of the year and allow for a strong deleveraging. This is necessary following the 2018 deterioration in credit metrics, chiefly due to the Ablynx and Bioverativ acquisitions (totalling EUR 12bn) but also to the slowdown in the vaccines business in H1 2018 and the ongoing patent expiry pressure on Sanofi's key blockbuster anti-diabetics drug, Lantus.

Credit metrics are therefore likely to recover to levels commensurate with the current rating by 2019, only one year after the acquisitions. Deleveraging will be supported by a much improved demand for vaccines (H1 2019 sales up by 22.5% year-over-year), slower-declining sales of products subject to patent expiry (mainly Lantus), and rising sales from newly approved products (mainly immunology drug Dupixent and acquired products such as haemophilia drug Eloctate and rare-blood-disorder drug Alprolix; both from Bioverativ). We expect the net effect to be very positive in 2019, thus supporting management's claim of a new growth phase for the group. Moreover, the new CFO is likely to focus more on cost control and cash generation, which supports the ratings.

The ratings continue to be supported by our perception of the anti-cyclical and protected pharmaceutical industry as well as Sanofi's solid competitive position in anti -diabetics, rare diseases, multiple sclerosis, vaccines and consumer healthcare. Another credit-positive factor relates to the group's five blockbuster drugs, each generating more than USD 1bn of annual revenues. Sanofi's long track record of stable operating profits, and translating these into equally stable cash generation, also benefits the rating.

Ratings & Outlook

Corporate ratings	AA/Stable
Short-term rating	S-1+
Senior Unsecured Rating	AA

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Related methodology

Corporate Rating Methodology

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Sanofi's financial risk profile is slightly stronger than its business risk profile. This is despite the significant deterioration in credit metrics during 2018 due to the Bioverativ and Ablynx acquisitions, combined with the Lantus patent expiry. While this depressed credit metrics in 2018, we expect a rapid recovery in 2019, supported by the very strong performance in H1 2019. If the new management continues to pursue the conservative financial policy, Sanofi's credit metrics are likely to reach levels needed for the present ratings, namely a free operating cash flow/Scope-adjusted debt (FOCF/SaD) ratio of 40%. In detail, the strong free operating cash flow in H1 2019 was supported by good like-for-like revenue growth of 4.1%, which led to robust profitability. As a result, free operating cash flow more than doubled from the level in the same period in 2018, when the figure was depressed by low vaccines demand. Cash generation was stronger in H1 2019 in a year-on-year comparison despite higher restructuring payments.

We expect significant debt reduction during H2 2019; deleveraging is usually hampered in the first half of the year by dividend payouts. The new CEO's conservative approach and focus on cost control are likely to aid deleveraging, and Scope therefore expects neither a higher dividend nor sizeable acquisitions for the remainder of 2019. On the other hand, this is also too early to judge, as the CEO was appointed just a few days ago.

Outlook

The Outlook is Stable and reflects our expectation that Sanofi can continue to maintain an FFO/SaD ratio of 60% as well as an FOCF/SaD ratio of 40% after 2018 (a year in which metric levels were worse than expected).

A higher rating could be the consequence of a stronger financial risk profile, namely credit metrics improving towards a net cash position. Alternatively, an improved business risk profile via higher profitability and improved diversification (through improved product concentration rates) could result in a positive rating action in the future.

A negative rating action could be the result of the above-referenced ratios falling back to levels of below 60% and 40%, respectively, on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Among the globally leading pharma companies • Comparatively diversified player • Credit-supportive underlying industry • Strong ability to generate free cash flow	• Comparatively low operating margins • Leading product Lantus under pressure • Dilutive effect from recent acquisitions

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Increasing margins and free cash flow • Development of a net cash position	• Further M&A eroding credit metrics • Inability to maintain at least an FFO/SaD of 60% and an FOCF/SaD of 40%

Financial overview

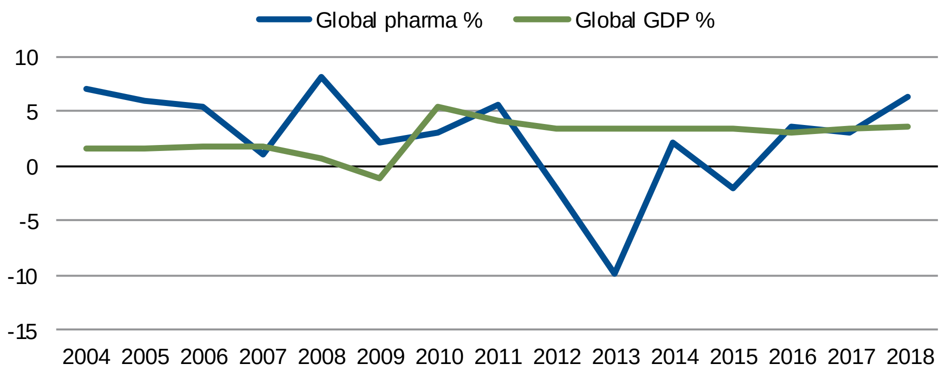
			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019F**	**2020F**
SaD/EBITDA (x)	0.8	2.3	1.7	1.3
Scope-adjusted FFO/SaD (%)	94	32	46	62
FOCF/SaD (%)	70	17	37	52
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	9,489	8,955	9,705	10,465
Operating lease payments in respective year	294	289	289	289
Other items	**0**	**0**	**0**	**0**
Scope-adjusted EBITDA	9,783	9,244	9,994	10,754
Scope funds from operations in EUR m	**2017**	**2018**	**2019F**	**2020F**
EBITDA	9,489	8,955	9,705	10,465
less: (net) cash interest as per cash flow statement	-291	-339	-335	-295
less: cash tax paid as per cash flow statement	-1.731	-2.058	-1.500	-1.500
add: depreciation component, operating leases	234	213	198	198
less. pension interest	-92	-75	-80	-85
Other items	173	173	0	0
Scope funds from operations	7,779	6,869	7,988	8,783
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019F**	**2020F**
Reported gross financial debt	15,601	24,640	20,000	17,500
less: cash, cash equivalents	-10,315	-6.925	-5,915	-6,255
Cash not accessible	500	500	500	500
add: pension adjustment	1.322	1.140	923	773
add: operating lease obligation	1.201	1.829	1.728	1.728
Scope-adjusted debt	8.308	21.184	17.236	14.247

Business risk profile

Non-cyclical industry

Over the last 14 years, the compound average growth rate of revenues in the pharmaceutical industry was about 4%, with a peak of 10% in 2007 and a trough of -2% in 2012. This compares to a global average GDP growth of about 2.5% over the same period. While the pharma market also shows periods of cyclicality, they are unrelated to macroeconomic indicators; rather, cycles are due to patent expiry and the development of new, promising medicines. Healthcare markets generally benefit from an ageing population and the spread of unhealthy lifestyles. We thus assess the sector's cyclicality as low.

Figure 1: Pharmaceutical market growth versus global GDP



Source: Eurostat, EvaluatePharma

High entry barriers/ medium substitution risk

When applying the Corporate Rating Methodology, we view barriers to entry in the innovative pharmaceutical industry as high. This assessment results from our view of the industry's high capital intensity, including substantial R&D investment, the protected nature of the market via patents, and the industry's consolidated structure.

We assess the substitution risk for the pharmaceutical sector as medium.

The combination of the three industry risk drivers, according to our Corporate Ratings Methodology, results in an industry risk for Sanofi of AA.

Competitive position

Market shares

Strong diabetes franchise

Sanofi's strong market position in anti-diabetics through Lantus, its global blockbuster drug (more than USD 1bn in annual revenues), is a particular support to the rating. While Lantus' revenues have steadily declined since 2015 (due to generic competition and price concessions made by Sanofi, mainly in the US), it is still likely to generate about EUR 3bn in revenues in 2019. However, the group's total diabetes franchise around its flagship product is significantly larger (around EUR 5.5bn) and includes Toujeo, the follow-on product of Lantus. The new drug's revenue ramp-up was slower than expected and might fall short of attaining blockbuster status in 2019.

Figure 2: Top five global diabetes players in 2018

Company	2018 sales (USD m)
Novo Nordisk	13,653
Eli Lilly	8,902
Sanofi	6,031
Merck & Co	5,900
Astra Zeneca	3,965

Source: Annual reports

Besides anti-diabetics, Sanofi also has significant market positions in vaccines and rare diseases. In vaccines, the group has maintained a fourth position globally, based on projected annual sales of more than EUR 5bn for 2018. This division is growing strongly thanks to new innovative products and high demand in emerging markets. In rare diseases, Sanofi is a global leader, with annual sales of about EUR 3bn following the takeover of US-based Genzyme in 2011. Outside of classic pharmaceuticals, Sanofi has also reached a critical size in global consumer healthcare. The acquisition of Boehringer Ingelheim's activities in 2016 has resulted in Sanofi being on par with worldwide market leaders Bayer and GSK, with annual sales likely to approach EUR 5bn in 2019.

Product portfolio

Five blockbuster drugs

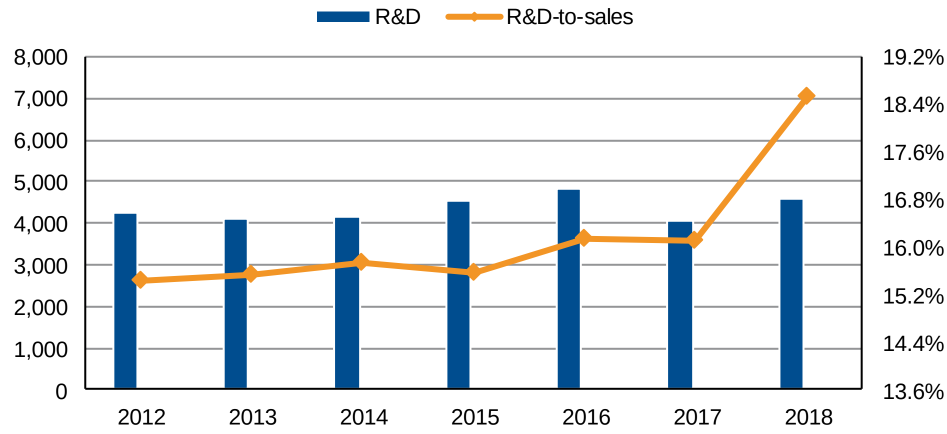
We believe Sanofi's range of five blockbuster drugs is credit-positive. These sizeable products are typically much more profitable than smaller drugs are, as their maturity and lower marketing expenses allow for higher profitability. In addition, Lantus, despite declining sales, is still likely to remain the most profitable drug for the group. Sanofi's other blockbusters include Plavix and Lovenox (cardiovascular), Aubagio (multiple sclerosis), and newly approved Dupixent (immunology); Toujeo is likely to get very close to blockbuster status in 2019. Dupixent increased H1 2019 sales by 175% to EUR 825m, in a year-on-year comparison. As Lantus declines in importance, each leading product is projected to generate annual sales of between EUR 1bn and EUR 3bn, thereby keeping product concentration rates lower than before.

Pipeline and R&D

Deep late-stage pipeline

In our view, Sanofi allocates sufficient resources into R&D, at 15%-20% relative to innovative pharma sales, equivalent to a high A category rating. The group's long, sustained effort has contributed to a strong product portfolio over time.

Figure 3: Continuously high pharma R&D (EUR m)



Source: Sanofi

The group's late-stage pipeline is a combination of R&D in existing franchises (e.g. diabetes, rare diseases and oncology) and the development and strengthening of the fields of haematology and rare blood diseases. The latter indication primarily benefits from the acquisitions of Bioverativ and Ablynx, while Sanofi's collaboration with US-based mid-sized biotech Regeneron has benefited its immunology franchise, which consists of Kevzara (rheumatoid arthritis), Dupixent and Praluent (cardiovascular), which are already marketed. We nevertheless believe that Sanofi's pipeline quality has suffered since a year ago, as the number of new molecular entities in phase 3 has declined to eight at the end of June 2019 from 11 one year earlier.

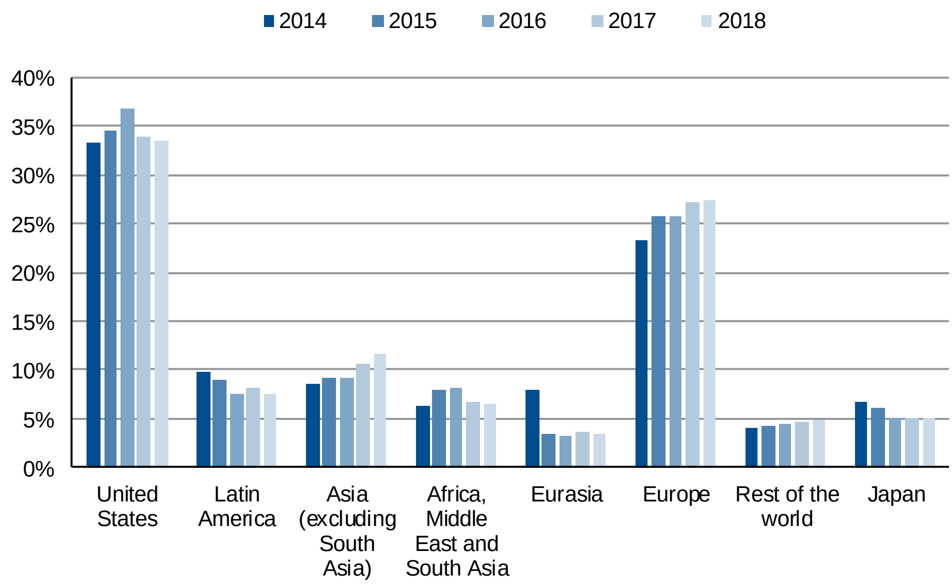
Due to patent expiry, Lantus is expected to have a comparatively lesser impact at Sanofi from now on. While Lantus lost slightly more than EUR 1bn in sales due to generic competition in both 2017 and 2018 (year-on-year), revenue loss in 2019 is expected at only about EUR 600m. This means the group's largest patent expiry threat is becoming less of an issue, even more so as there are no other sizeable drugs affected by the loss of exclusivity. On the other side, newly approved drugs in 2019 are likely to contribute significant additional sales, namely Dupixent, Aubagio, Eloctate (haemophilia) and Admelog (diabetes). According to our pharma-specific methodology, if a patent expiry-driven loss in sales is likely to be offset by sales from new innovative products, this equates to an implied rating of A or higher. We believe there are good chances of this from 2019, as detailed above.

Diversification

Diversification improved due to lower product concentration

Sanofi's credit quality is supported by its corporate structure, as it is still (despite recent divestitures) more diversified than most of its global pharma peers – consolidating top-five positions in four large global markets (diabetes, rare diseases, vaccines, consumer healthcare). Within innovative pharmaceuticals, an exposure to six sizeable and different treatment areas (including vaccines) is similarly positive from a credit perspective. Furthermore, the group's geographical breakdown of sales continues to be well diversified, with strong exposures to the still high-margin US market, Europe, and emerging markets (the latter being important for growth potential).

Figure 5: Sanofi's geographical diversification by revenues



Source: Sanofi

We believe the group's diversification has significantly contributed to its historical and superior stability in operating profits and cash flows, avoiding the negative effects from blockbuster patent expiry that have been more prominent for other peers.

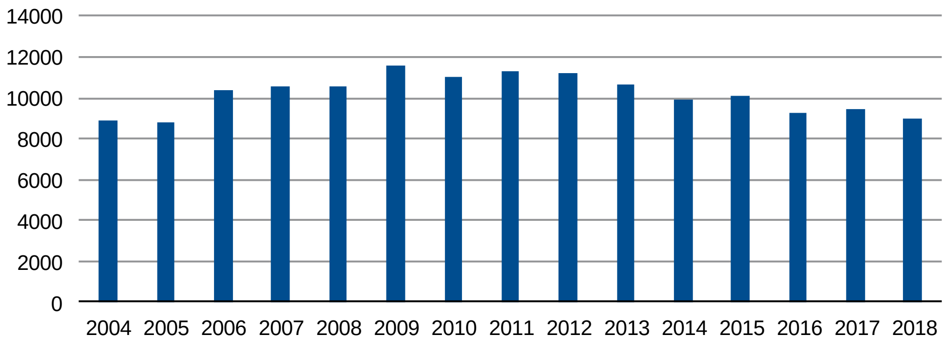
While product concentration rates have been high historically – connected to the weight of Lantus, they have considerably mdified since 2017 – the top-three drugs now account for 28% of total pharma sales (from 35% in 2016), which is positive for the rating.

Operating margins

Comparatively low operating margins – but historically stable EBITDA generation

Sanofi has low operating margins compared with peers', which is surprising given the company's size and positioning. However, operating margins include generics and consumer healthcare, which generally have much lower margins than for innovative pharmaceuticals. Additionally, the relatively large Established Products portfolio and emerging markets exposure, with sales of more than EUR 14bn, dilute reported margins further.

Figure 8: Underlying estimated EBITDA calculation (EUR m)



Source: Annual reports

While this has reduced the group's operating margin over time, EBITDA – and cash generation – has been comparatively stable over the last 15 years, given the above, with absolute EBITDA in a range of EUR 9bn-12 bn.

Business risk profile rated AA-

We continue to assess Sanofi's business risk profile at AA-. This includes the AA category industry risk and our competitive positioning assessment (A+). The latter primarily considers Sanofi's strong market shares, product portfolio, and our combined pipeline/R&D assessment, which are partly offset by below-average operating margins and our view on the slightly lower quality of the late-stage pharmaceutical pipeline than from a year ago.

Financial risk profile

Credit metrics

Sanofi's credit metrics have been stable and strong historically and we do not predict a deviation from this pattern for the next two years (Figure 9). The exception of a stark deterioration expected in 2018 was due to EUR 13bn in acquisitions coupled with Lantus patent expiry.

Figure 9: Scope credit ratios

Scope credit ratios	2015	2016	2017	2018	2019F	2020F
Scope-adjusted debt/EBITDA (x)	1.1	1.2	0.8	2.3	1.7	1.3
Scope-adjusted FFO/Scope-adjusted debt (%)	72	62	94	32	46	62
Free operating cash flow/Scope-adjusted debt (%)	51	50	70	17	37	52

Source: Scope

Based on a strong H1 2019 performance, we expect Sanofi's credit metrics to again be in line with its AA financial risk profile by the end of 2019. This is based on the following trends we have reflected in our base-case assessment:

- Group revenue growth of about 5%-6% for FY 2019 and 1%-2% for FY 2020. For pharmaceuticals (including vaccines), we expect revenues to grow by 6% in 2019, and 2% in 2020, while expected growth should be about 3% in consumer healthcare for both years

- Continued sales decline in diabetes and cardiovascular franchises due to the patent and price erosion on Lantus, offset by strong growth in the areas of rare diseases, multiple sclerosis, immunology and vaccines
- 7%-10% growth in EBITDA for both projected years, based on top-line dynamics and helped by management's cost containment, whose effect is likely to be felt by 2020
- No further major acquisitions
- 60%-70% of net profits distributed as dividends
- Discretionary cash flow of about EUR 4bn in 2019, enabling deleveraging
- No share buybacks in current phase of credit metrics recovery

Figure 10: Expected rise in free cash flow in 2019

Free cash flow	2016	2017	2018	H1/19	2019F	2020F
Funds from operations (unadjusted)	**7,244**	**7,523**	**6,013**	**3,905**	**7,870**	**8,670**
Less: capex (net)	-1,873	-1,606	-1,877	-833	-1,400	-1,600
Change in working capital	292	-97	-466	-684	-174	70
Other items	363	0	0	0	0	0
Free cash flow	**6,026**	**5,820**	**3,670**	**2.388**	**6,296**	**7,140**
Dividends	-3,780	-3,725	-3,787	-3,834	-3,834	-4,000
Acquisitions (net)	-425	2758	-10,831	746	1,400	0
SBBs	-2,603	-1,843	-924	-9	100	-200
Discretionary cash flow	**-782**	**3.010**	**-11,872**	**-709**	**3,930**	**2,940**

Source: Sanofi annual reports, Scope estimates and adjustments

We believe Sanofi is highly likely to continue a stable pattern of cash generation in the foreseeable future. This pertains to three factors: i) annual funds from operations of EUR 8bn-9bn; ii) free cash generation of EUR 6bn-7bn; and iii) a rebound in discretionary cash flow after the effects of the 2018 acquisitions. The strong expected deleveraging effect in 2019 will also bolstered by the realisation of disposal proceeds – close to EUR 900m were already received during H1 2019 – as well as new management's spending discipline with regard to the discretionary elements. This, together with the operating improvements already explained, is likely to more than compensate for the higher restructuring spend of EUR 1.5bn in 2019.

Main debt constituents are pensions (Scope-adjusted, as pension assets cover annual payments by substantially more than our 6x threshold to apply a 50% haircut for the 'gap'), and operating leases of now below EUR 1bn.

Liquidity

We view the group's liquidity as above average. Limited short-term debt on the balance sheet is met by an ample cash balance of EUR 6bn-7bn per year combined with undrawn committed lines of EUR 8bn. The short-term rating is S-1+, in line with the mapping in our rating methodology.

Supportive financial risk profile

Sanofi's financial risk profile is rated AA according to our methodology. This is based on our perception that the group will continue to deliver high and stable credit metrics in the foreseeable future. Management's financial policy also supports the rating. It is too early to determine the effects of the change in CEO from 1 September 2019 and we will evaluate this in due course. It remains our understanding that management is strongly committed to maintaining the ratings.

Outlook

The Outlook is Stable and reflects our expectation that Sanofi can continue to maintain an FFO/SaD ratio of 60% as well as an FOCF/SaD ratio of 40% after 2018 (a year when metric levels were worse than expected).

A higher rating could be the consequence of a stronger financial risk profile, namely credit metrics improving towards a net cash position. Alternatively, an improved business risk profile via higher profitability and improved diversification (through improved product concentration rates) could result in a positive rating action in the future.

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