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 comprise vaccines and over-the-counter (OTC) products. The animal health business was divested and the European generics business 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.

Key metrics

			Scope estimates	
Scope credit ratios	2018	2019	2020F	2021F
SaD/EBITDA (x)	2.3	1.7	1.1	1.2
Scope-adjusted FFO/SaD (%)	32	47	68	73
FOCF/SaD (%)	17	35	50	55

Rating rationale

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

The affirmation mainly reflects our view of greatly improved operating trends and cash generation in the last 12 months providing good deleveraging potential. This is based on very strong demand for newly approved dermatology/ inflammation drug Dupixent, which is more than compensating for declining sales in Sanofi's formerly largest product Lantus (anti-diabetics). At the same time, newly adopted, rigorous cost discipline and about EUR 10bn in divestiture proceeds for the 21% stake in cooperation partner Regeneron, helped to elevate group cash generation significantly at the end of the first half 2020, in a year-on-year comparison.

We therefore believe credit metrics are very likely to improve greatly in 2020 compared to the year before. This is despite a mixed picture regarding performance of some products in the first six months of the year as the coronavirus crisis unfolded while group results were overall resilient. For the second half of the year, we expect Sanofi's vaccines segment to perform strongly, assuming a certain normalisation of patient access and hospital services in most countries. This is not so much due to a potential new Covid-19 vaccine approval but rather to a pent-up and generally increased demand for travel as well as traditional influenza vaccines as an expression of most populations' higher safety priorities in the wake of the present crisis. As one of the leading global vaccine producers, Sanofi is very likely to benefit considerably, in our view.

The ratings continue to be supported by 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 health care and for Dupixent. In addition, the group's enlarged product portfolio of seven blockbuster drugs (generating more than USD 1bn of annual revenues) further supports the ratings. The rating also benefits from Sanofi's proven, long-term track record of stable operating profit generation, translating into equally stable cash generation.

Ratings & Outlook

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

Analysts

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Related Methodology

Corporate Rating Methodology, February 2020

European Pharmaceuticals, January 2020

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Sanofi's **financial risk profile** (rated AA) is slightly stronger than its business risk profile from a ratings perspective. This is despite credit metrics' significant deterioration in 2018 due to the acquisitions of Bioverativ and Ablynx, combined with the Lantus patent expiry. While this led to temporarily depressed credit metrics in 2018, they recovered quickly in 2019, supported by a much improved patent expiry protection profile, mainly helped by the significant rise in Dupixent revenues. In addition, metrics have also been supported by management's cost control programme, which has already benefited cash generation in the last 12-18 months. Continuation of the group's historically proven conservative financial policy by new management has brought Sanofi's credit metrics very close to levels in line with present ratings, namely free operating cash flow (FOCF)/Scope-adjusted debt (SaD) of 40%. This is despite the negative impact of the coronavirus crisis, particularly in the second quarter of the year.

In detail, relatively strong free cash generation in the first six months of 2020 was supported by resilient revenues in the face of the crisis (-3% year-on-year) as well as by cost control, leading to a negligible operating margin impact relative to the first half of 2019. This good performance, given the circumstances, also reflects greater asset management efficiency, which mitigated the impact of the crisis. Consequently, free operating cash generation in the first half of 2020 was up in a year-on-year comparison. Deleveraging is usually difficult to achieve for Sanofi in the first half of the year, due to the dividend payout which falls within the period. However, 2020 greatly benefitted from the EUR 10.5bn Regeneron divestiture gain. Based on this, and the fact that the acquisition of Principia Biopharma Inc for about USD 3.7bn was executed in the third quarter, we believe that more significant deleveraging is likely for the full year 2020, assuming a good vaccines season and a normalisation of the hospital business. We do not expect additional sizeable acquisitions in the remainder of 2020, while the confirmed absence of share buybacks in 2020 is an additional support to the ratings.

Outlook

The Outlook is Stable and reflects our expectation that Sanofi can reach and continue to maintain a funds from operations (FFO)/SaD ratio of 60% as well as an FOCF/SaD ratio of 40% following the 2019 recovery from depressed 2018 credit metric levels. A higher rating could be the consequence of a stronger financial risk profile, with credit metrics improving towards a net cash position. Alternatively, an improved business risk profile via higher profitability and improved diversification (with better product concentration rates) could result in a positive rating action in future. A negative rating action could result from the above ratios falling back to levels below 60% and 40%, respectively, on a sustained basis.

Rating drivers

Positive rating drivers	Negative rating drivers
• Globally leading pharma company • Comparatively diversified player • Credit-supportive underlying industry • Strong free cash generating capability	• Comparatively low operating margins • Leading product Lantus under pressure • Recent acquisitions were dilutive

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
• Increasing margins and free cash flow • Credit metrics moving towards net cash position	• Future erosion of credit metrics due to further M&A • Inability to maintain at least FFO/SaD of 60% and FOCF/SaD of 40%

Financial overview

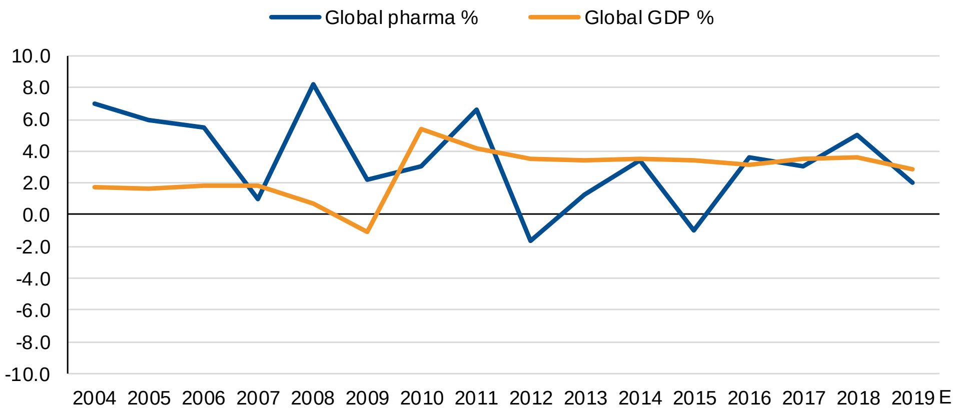
			Scope estimates	
Scope credit ratios	**2018**	**2019**	**2020F**	**2021F**
SaD/EBITDA (x)	2.3	1.7	1.1	1.2
Scope-adjusted FFO/SaD (%)	32	47	68	72
FOCF/SaD (%)	17	35	50	55
Scope-adjusted EBITDA in EUR m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	8,955	10,475	10,568	10,275
Operating lease payment in respective year	289	-	-	-
Other	**0**	**0**	**0**	**0**
Scope-adjusted EBITDA	9,244	10,475	10,568	10,275
Scope funds from operations in EUR m	**2018**	**2019**	**2020F**	**2021F**
EBITDA	8,955	10,475	10,568	10,275
less: (net) cash interest as per cash flow statement	-339	-287	-270	-210
less: cash tax paid as per cash flow statement	-2.058	-1.695	-2.000	-1.250
add: depreciation component operating leases	213	-	-	-
less. pension interest	-75	-87	-85	-85
other	173	0	0	0
Scope funds from operations	6,869	8,406	8,213	8,730
Scope-adjusted debt in EUR m	**2018**	**2019**	**2020F**	**2021F**
Reported gross financial debt	24,640	25,933	20,000	17,500
less: cash, cash equivalents	-6,925	-9.427	-7,210	-6,025
Cash not accessible	500	500	500	500
add: pension adjustment	1.140	923	773	624
add: operating lease obligations	1.829	0	0	0
Scope-adjusted debt	21.184	17.928	12.063	12.098

Business risk profile

Non-cyclical industry

Based on historical sector trends over the last 14 years, the compound average growth rate of revenues in the pharmaceutical industry has been about 4%, with a peak of 10% in 2007 and a trough of -2% in 2012. This compares to global average GDP growth of about 2.5% over the same period. While the pharma market also has periods of cyclicality, they are completely unrelated to macroeconomic indicators. Rather, cycles are due to patent expiry and the development of new, promising medicines. Generally, healthcare markets 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 assessed in accordance with our Corporate Rating Methodology, barriers to entry in the innovative pharmaceutical industry are high. This is based on high capital intensity, including substantial R&D investments, the protected nature of the market via patents, and the consolidated structure of the industry.

We assess substitution risk for the pharmaceutical sector as medium.

As per our Corporate Ratings Methodology, the combination of these three industry risk drivers results in an industry risk for Sanofi of AA.

Competitive position

Market shares

Three strong franchises

While Sanofi still has a strong market position in anti-diabetics (mainly through its blockbuster drug Lantus), the group has built sizeable positions in two other pharmaceutical segments – namely rare diseases and vaccines. Sanofi's diabetes drug sales have declined over the last few years in the wake of generic competition and price pressure (mainly in the US, reflecting health care payors' drive for cost efficiency in this large treatment area). While Lantus is still likely to generate about EUR 2.5bn in revenues in 2020, the performance of Sanofi's rare disease and vaccines segments has been more stable in recent years.

Sanofi is a very sizeable global player in rare diseases (flagship products Myozyme for Pompe disease – likely to become a blockbuster product in 2020, and Fabrazyme for Fabry disease – only slightly smaller) with annual segment sales of about EUR 3bn following the takeover of US-based Genzyme in 2011. In vaccines, the group has maintained a number four position globally, based on projected annual sales of EUR 5.7bn in 2019. This division is growing strongly thanks to new innovative products and high demand in emerging markets. As one of only four major vaccine manufacturers worldwide, Sanofi also stands to benefit from significantly increased demand this year in the wake of the coronavirus crisis and most populations' increased safety priorities. This is unrelated, in our opinion, to the potentially successful development of a new Covid-19 vaccine by Sanofi and its partner GSK.

Figure 2: Top five global diabetes players in 2019

Company	2019 sales (EUR bn)
Novo Nordisk	13.0
Eli Lilly	9,4
Sanofi	5.0
Merck & Co	4.7
Astra Zeneca	4.3

Source: Annual reports

Outside of classic pharmaceuticals, Sanofi has also reached a critical size in global consumer healthcare. Following the acquisition of Boehringer Ingelheim's activities in 2016, Sanofi became a leading global player in this market, with annual sales approaching EUR 5bn. In 2019, however, GSK announced a joint venture with Pfizer Inc, to create the largest consumer healthcare company by far, with more than EUR 10bn in annual sales.

Product portfolio

Seven blockbuster drugs

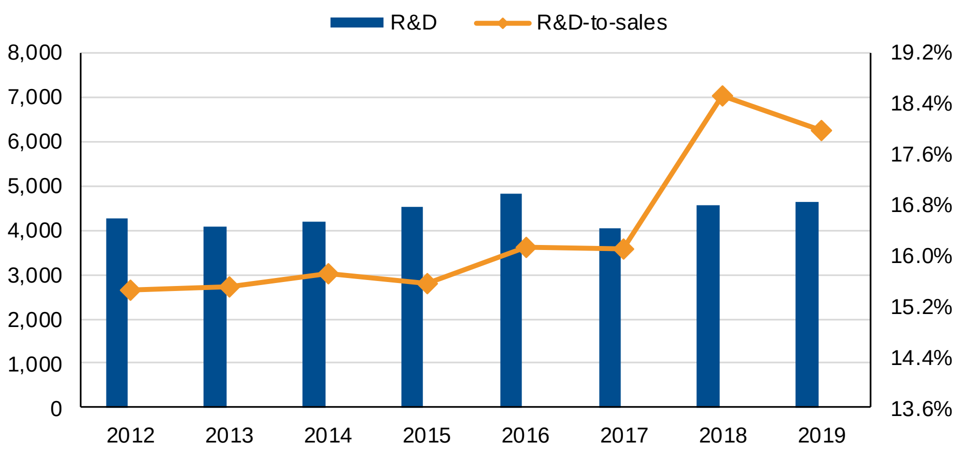
We believe Sanofi's enhanced count of seven blockbuster drugs is credit-positive. These major products are typically much more profitable than smaller drugs, as their maturity and lower marketing expenses allow for higher profitability. In addition, Lantus is still likely to remain the most profitable drug for the group for the time being, in our view, despite declining sales. Sanofi's other blockbusters include Plavix and Lovenox (cardiovascular), Aubagio (multiple sclerosis), as well as newly approved Dupixent (immunology) with Toujeo likely to come very close to that status in 2020. Dupixent was already Sanofi's second-largest pharma product in 2019 and is likely to become the largest at the end of 2020. With seven blockbusters in total, Sanofi compares well to its big pharma peers Pfizer (eight) and Roche (nine).

Pipeline and R&D

Good late-stage pipeline

In our view, Sanofi allocates sufficient resources to R&D, with a ratio of R&D to innovative pharma sales of 15%-20%, which is 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. Dupixent in particular has recorded a very successful revenue increase in 2019 and the first half of 2020 (+150%/ +94% compared to 2018 and the first six months of 2019, respectively, on a constant-currency basis), based on its efficacy profile and strong demand in atopic dermatitis and asthma. We nevertheless believe that Sanofi's pipeline quality has suffered since 2018, as the number of new molecular entities in phase 3 declined to eight from 11 in 2018 (several projects were discontinued following management's more focused R&D approach).

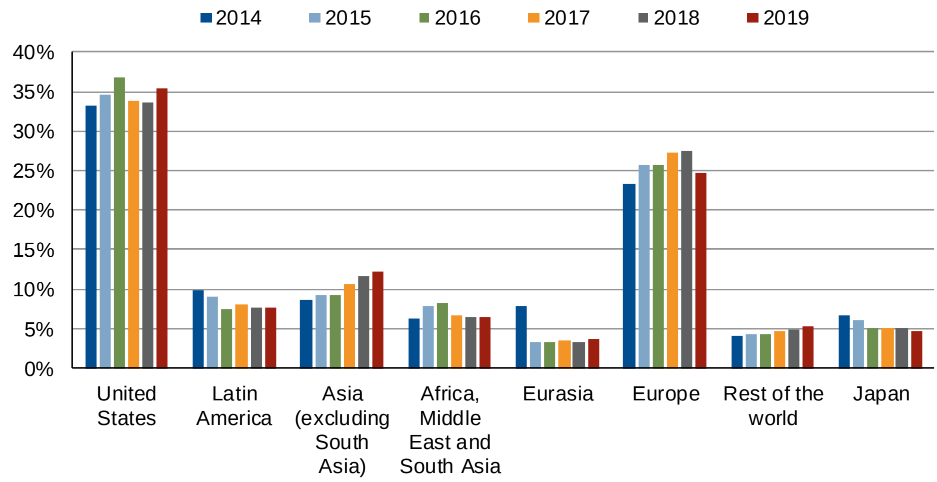
We expect the impact of patent expiry on Lantus to decrease from now on. While the drug lost slightly more than EUR 1bn in sales due to generic competitors in both 2017 and 2018 (year-on-year), it lost only about EUR 550m in 2019 and we expect similar magnitudes for 2020. This means that the group's largest patent expiry threat has already become less of an issue, particularly as no other sizeable drugs are affected by a loss of exclusivity. At the same time, newly approved drugs are likely to contribute significant additional sales, namely Dupixent and Aubagio, while Eloctate (haemophilia) appears to have been suffering from Roche's competitive product Hemlibra. According to our pharma-specific methodology, if a loss in sales due to patent expiry is likely to be fully offset by sales of new innovative products, this equates to an implied rating of A or higher. We believe Sanofi has significantly improved in this respect over the last 12-18 months, as detailed above. Therefore, we have moved the rating for this category higher by one notch to A+ overall.

Diversification

Diversification unchanged

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). In innovative pharmaceuticals, exposure to six major 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 overall diversification has significantly contributed to its historically highly stable operating profits and cash flows, avoiding the negative effects from blockbuster patent expiry that have been more prominent for other peers.

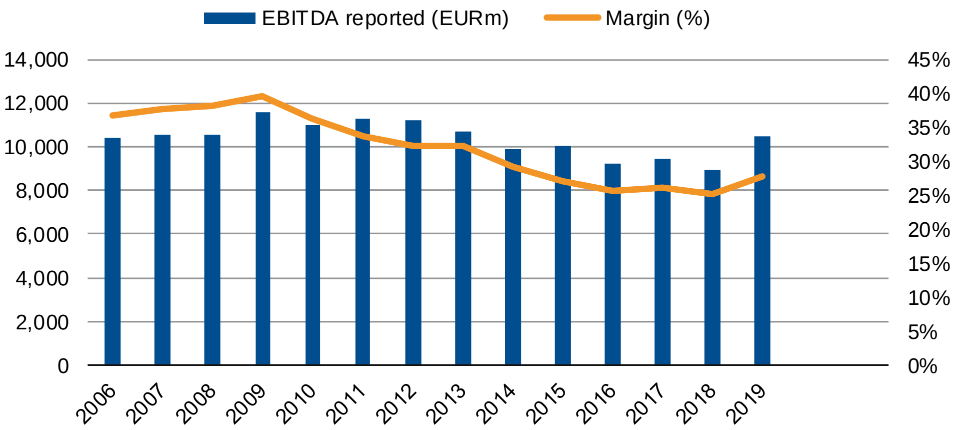
While product concentration rates have been moderating since 2017 – linked to Lantus' reduced weight, there was counter-movement in 2019 due to Dupixent's rapid growth and the larger number of blockbusters versus a year ago. Top-three drugs now account for 33% of total pharma sales (versus 28% in 2018), which is positive for the rating.

Operating margins

Formerly low operating margins have started to increase lately

Sanofi has low operating margins compared with peers, which is surprising given the company's size and positioning. However, reported operating margins include generics and consumer healthcare, which generally have much lower margins than innovative pharmaceuticals. Additionally, the relatively large established products portfolio and emerging markets exposure, with sales of more than EUR 15bn, dilute reported margins further, in our view.

Figure 8: Reported EBITDA – historical trends



Source: Annual reports

While the group's operating margin has thus come down over a long period since 2009, EBITDA – and cash generation – has been comparatively stable over the last 15 years, given the above, with absolute EBITDA in a range of EUR 9-12bn. The group EBITDA margin started to improve significantly in 2019 (+ 2.7 basis points) and in the first half of 2020 (27.2% – including a weak Q2 contribution due to negative Covid-19 effects).

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 (AA-). The latter has been upgraded by one notch to reflect improvements in the last 12 months in Sanofi's patent expiry profile and product portfolio.

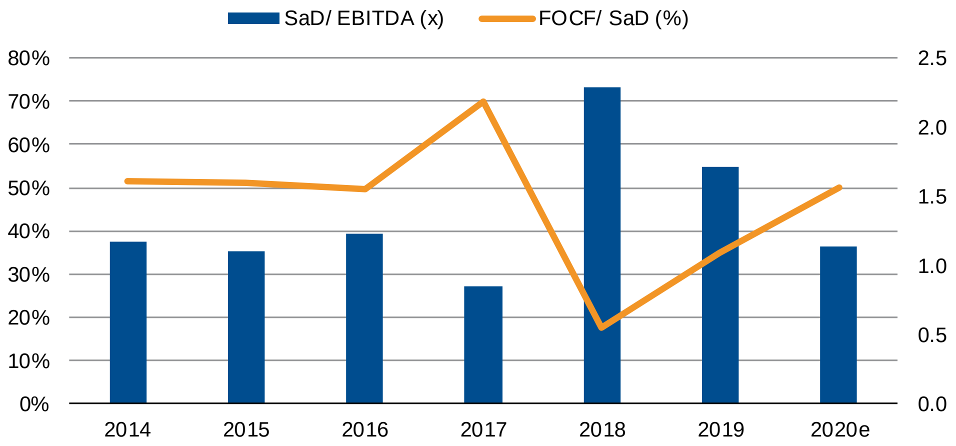
Financial risk profile

Credit metrics

Credit metrics in strong catch-up mode

Sanofi's credit metrics have been stable and strong historically and we do not predict a departure from this pattern in future (Figure 9). The unusually sharp deterioration in 2018 was due to about EUR 13bn in acquisitions coupled with the Lantus patent expiry.

Figure 9: Scope credit ratios



Source: Scope

Following the release of strong 2019 and first-half 2020 performance figures, we expect Sanofi to return to credit metrics in line with its AA financial risk profile by the end of the current year. This is based on the following trends reflected in our base-case assessment:

- Group revenue growth of about 2% for both FY 2020 and 2021, reflecting purely organic trends and a subdued first half of 2020 due to the coronavirus crisis (hospital capacity constraints, restricted patient access). It also reflects our assumptions of a 2%/3% growth in vaccine revenues, respectively, which may prove conservative given the likely coronavirus-crisis prompted demand in this segment.
- Expectation of continued sales declines in diabetes and cardiovascular/established products segments due to the patent erosion of leading drugs offset by strong likely growth in the specialty care unit (rare diseases, multiple sclerosis, blood disorders and Dupixent)
- Stable EBITDA assumed for both projected years, compared to 2019, reflecting the ongoing transformation of the company coupled with necessary expenses for restructuring in the context of the group's operational excellence programme
- No further major acquisitions
- 60%-70% of net profits distributed as dividends
- Discretionary cash flow of about EUR 4bn in 2020, enabling deleveraging
- No share buybacks in current year

Figure 10: Expected rise in free cash flow in 2020

Free cash flow	2017	2018	2019	H1/20	2020F	2021F
Funds from operations (unadjusted)	**7,464**	**6,013**	**8,584**	**5,152**	**8,298**	**8,815**
less: capex (net)	-1,559	-1,877	-1,516	-682	-1,800	-2,000
Change in working capital	**-85**	**-466**	**-840**	**-832**	**-482**	**-200**
Free cash flow	**5,820**	**3,670**	**6,228**	**3.638**	**6,016**	**6,615**
Dividends	-3,725	-3,787	-3,848	-3,937	-4,000	-4,000
Acquisitions (net)	2.758	-10.831	698	8.152	3,500	-3,000
Share buybacks (net)	-1,843	-924	162	-361	200	200
Discretionary cash flow	**3,010**	**-11,872**	**3,240**	**7,492**	**5,716**	**-195**

Source: Sanofi annual reports, Scope estimates and adjustments

Sanofi's cash generation is highly likely to at least remain stable in the foreseeable future. This assumption is based on three factors: i) annual funds from operations of EUR 8bn-9bn; ii) free cash generation of EUR 6bn-7bn; and iii) rebounding discretionary cash flow after the 2018 acquisitions. The realisation of disposal proceeds will also support the strong expected deleveraging effect in 2020. About EUR 10.5bn were already received in the first six months of the year from the disposal of the group's Regeneron stake. This, together with new management's spending discipline with regard to discretionary elements and the abovementioned operating improvements, should provide ample room for deleveraging, despite bolt-on acquisitions of about EUR 7bn (Synthorx and Principia).

Following the application of IFRS16, which brought operating leases onto the balance sheet, the main additional debt constituents are now restricted to pensions (Scope-adjusted, as pension assets cover annual payments by substantially more than our 6x threshold to apply a 50% haircut for the 'gap'). We deduct available cash from our SaD calculation, reserving EUR 500m as a proxy for restricted cash elements.

Liquidity

We view the group's liquidity as adequate for the ratings. Limited short-term debt on Sanofi's balance sheet is covered 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 as per our methodology. This is based on our view that the group will continue to deliver high and stable credit metrics in the foreseeable future. Management's financial policy also supports the rating. We do not expect any major additional acquisitions in the remainder of 2020, while the confirmed absence of share buybacks in 2020 is an additional support to the ratings. It remains our understanding that new management is strongly committed to maintaining the ratings.

Outlook

The Outlook is Stable and reflects our expectation that Sanofi can reach and continue to maintain an FFO/SaD ratio of 60% as well as an FOCF/SaD ratio of 40% following the 2019 recovery from depressed 2018 credit metric levels. A higher rating could be the consequence of a stronger financial risk profile, with credit metrics improving towards a net cash position. Alternatively, an improved business risk profile via higher profitability and improved diversification (with better product concentration rates) could result in a positive rating action in future. A negative rating action could result from the above ratios falling back to levels below 60% and 40%, respectively, on a sustained basis.

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