

BUSINESS INSIDER

VALEANT: How A Canadian Pharmaceutical Company Could Destroy The Industry As We Know It



MYLES UDLAND
JUN. 12, 2014, 8:51 AM



REUTERS/Stefan Wermuth

Valeant Pharmaceuticals is trying to acquire Allergan, the maker of Botox.

The tactics it's using to do so might end up killing the pharmaceutical industry.

Valeant first approached Allergan in April 2014. It has twice raised its bid, which it is making with hedge-fund

IPR2015-01099

IPR2015-01097

IPR2015-01100

IPR2015-01105

Lupin EX1146

Page 1

was made on May 30.

But Allergan [says](#) it isn't rejecting Valeant's bid because of price.

It's rejecting Valeant's business model.

Valeant's Business Model

Valeant is a pharmaceuticals company now domiciled in Canada. In 2010, Valeant acquired Canadian pharmaceutical company Biovail, and [following the acquisition](#) moved its headquarters to Montreal.

As of February, Canada's corporate tax rate was about 26.5% compared to about 40% in the U.S., according to data from KPMG.

Under CEO Michael Pearson, the company has executed more than 100 deals as part of a strategy to grow through acquisitions, [according to The Wall Street Journal](#).

On Valeant's [first-quarter conference call](#), Pearson said that in the first quarter alone, the company completed 10 transactions.

Pearson elaborated on what Valeant looks for in an acquisition, saying it looks at cash flow and what he called a "certain return to our shareholders."

When Pearson refers to a "certain return" for shareholders, he walks into a central criticism of Valeant's business

model: Namely that Valeant strips costs, including research, development and staff, from the companies it acquires and just sells their finished products.

But is low R&D spending sustainable?

Allergan's Self-Defense Strategy

In a [letter to Pearson](#), Allergan CEO David Pyott said Valeant's latest offer does not include enough "sufficient or certain value to warrant discussions between Allergan and Valeant."

In a May 12 letter rejecting Valeant's first increased offer, Pyott said:

Valeant's strategy runs counter to Allergan's customer focused approach. In particular, we question how Valeant would achieve the level of cost cuts it is proposing without harming the long-term viability and growth trajectory of our business. **For those reasons and others, we do not believe that the Valeant business model is sustainable.**

One of Allergan's main problems with Valeant's business model is that the company does not invest in research and development.

In its [latest presentation](#) rejecting Valeant's offer, Allergan said its 2013 R&D costs were equal to about 17% of its revenue, while Valeant's R&D spending was equal to about 2% of revenue.

On Valeant's first-quarter-earnings conference call, Pearson said he expects the company to exit 2014 with R&D

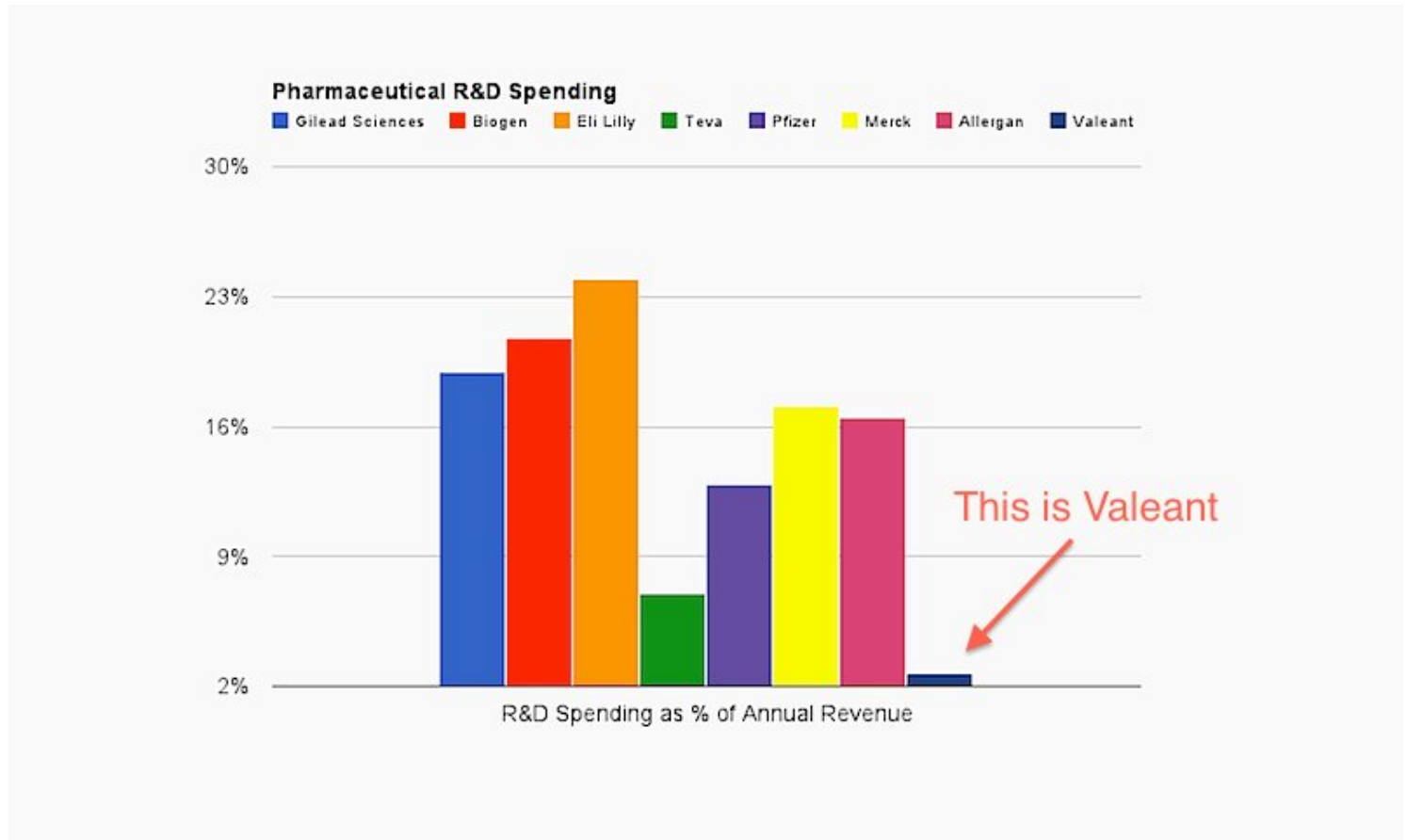


Bloomberg TV

Allergan argues that its R&D spending doesn't result in a bunch of wasted money. The \$7 billion it spent on R&D between 1992 and 2013 resulted in about \$50 billion in cumulative sales, the firm said.

The company also said additional R&D spending will result in \$120 billion in additional sales over the next 10 years.

This chart of R&D spending as a percentage of revenue drives home how much less Valeant spends on R&D than some of its biggest pharmaceutical rivals.



The Companies / Business Insider

Other Skeptics

Valeant's aggressiveness has gotten significant attention in the market. Jeremy Levin, former CEO of Teva Pharmaceuticals, [told The Wall Street Journal](#) that "Valeant will eventually run out of things to buy ... a company without R&D short term and midterm can be viable, but long term is not."

John Hempton, a noted finance blogger at Bronte Capital, has also [expressed concerns](#) about Valeant and is short the stock. He has promised a series of posts analyzing Valeant's financials.

Business Insider's Linette Lopez [detailed some of the problems](#) with Valeant's ploy, writing that Ackman and Valeant aren't seeking to buy Allergan but swallow it whole and digest it quickly.

Also following Valeant's first offer for Allergan, [The Financial Times' John Gapper argued](#) that if the entire pharmaceutical industry adopted Valeant's approach, drug discovery would grind to a halt.

Gapper outlined two visions for the pharmaceutical industry, one where companies invest heavily in new drugs and another where R&D spending is cut "to save cash and please Wall Street "

What Now?

Following Valeant and Ackman's latest offer, Ackman [disclosed in an SEC filing](#) that his Pershing Square fund is preparing a hostile bid for Allergan.

A hostile bid is when a potential acquirer engages directly with the shareholders of the company, rather than the company's board, regarding its takeover proposal.

A hostile bid now seems likely given that Allergan's CEO said Valeant's latest deal isn't worth discussing.

Ackman owns nearly 10% of Allergan's stock, and [the company has already adopted](#) a so-called poison-pill provision preventing any shareholder from acquiring more than 10% of the company, so his voting sway over Allergan's decision will not increase.

This story is unlikely to reach a conclusion soon: Citing analysts at BMO Capital, the [FT said](#) the fight could last "well into" 2015.

The Death Of Pharma?

Just this week, Merck [purchased pharmaceutical company](#) Idenix Pharmaceuticals for \$3.85 billion; in its first quarter, Idenix [recorded no revenues](#). And while Merck is certainly betting that Idenix's hepatitis-C drugs in development will be approved, the deal essentially amounts to a one-time R&D expense.

R&D spending is not dead.

But others have started to imitate Valeant's methods for boosting their stock price. [The Wall Street Journal notes](#) that Endo Pharmaceuticals has begun to adopt an acquisition strategy similar to Valeant's.

Shares of Endo are up more than 77% over the last year.

Valeant's strategy has also been a boon for shareholders, who have seen the stock gain more than eight times since Pearson joined the company as CEO in February 2008.

Whether or not Valeant and Ackman are successful in acquiring Allergan, this deal has raised eyebrows among investors and executives in both the pharmaceutical space and the broader market.

Expect pharmaceuticals companies to start taking closer looks at their strategies before someone else does.



Mike Nudelman/Business Insider

