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Pfizer-Allergan Merger: The End Is Nigh

by Mandy Jackson

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Long after the US stock market closed on Tuesday, reports emerged saying that Pfizer would announce on Wednesday, April 6, that the big pharma and Allergan agreed to terminate their deal. The transaction would've created the largest health care company in the world, but it was scuttled by Treasury rules designed to keep US-based corporations like Pfizer from buying companies like Allergan who benefit from a lower tax rate by keeping their legal home base outside of the US.

A Legal Fight With The US Unlikely

"The risks to the deal seem reasonably well understood by the Street, but until Pfizer announces its next move, we believe three outcomes are possible: 1) fight the new proposal – we see this as unlikely; 2) renegotiate [a] non-inversion deal with Allergan – possible in our view; or 3) walk away from the Allergan deal – we believe most likely," Jefferies analyst Jason Gerberry wrote in an April 5 note.

Post-merger, Pfizer would've taken on Allergan's Irish corporate address to lower its tax rate, while keeping the bulk of its administrative operations in the US. It now appears that Pfizer and Allergan have decided not to fund what could be a years' long legal battle to defend the structure of their deal.

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A fight against the Treasury Department's new rules was likely to take a lot of time and hundreds of millions of dollars, especially since President Obama emphasized his *passionate support* on April 5 for regulations that prevent the loss of billions in tax dollars via inversion deals – money that otherwise would be destined for US government coffers.

Pfizer CEO Ian Read and Allergan CEO Brent Saunders spent much of the past four and a half months – the time that's passed since they announced *the companies' merger in November* – on a road show *assuring employees* and investors that the deal was sound and that it would close without interference from government regulators.

Scrip *interviewed the executives* during the 34th Annual J.P. Morgan Healthcare Conference in January and received assurances from Read and Saunders that they were focused on closing the merger on time during the second half of 2016. Read again insisted during *Pfizer's fourth quarter 2015 earnings* conference call in early February that the transaction would close as planned, stating that, "Under current law, I do not believe there is any reason why this deal will not close."

Regulatory Risk Was Well-Known

But despite all of the companies' assurances, Pfizer and Allergan recognized the regulatory risk involved in their transaction given the political commentary against inversion deals that occurred for several months before they worked out a merger agreement. After all, AbbVie Inc. dropped its $53bn bid to acquired Shire PLC a year earlier *after the Treasury Department amended* inversion-related rules.

Since another tax law change was well within the realm of possibility, Pfizer and Allergan agreed to a $3.5bn breakup fee that would *drop to just $400m* if they had to terminate their merger due to a legal change preventing the tax inversion.

Ironically, it was Allergan's and its CEO's dealmaking ways that undermined the merger with Pfizer. *The Treasury rule changes*, which appeared to be written with the Pfizer-Allergan deal in mind, changed the way in which businesses are valued for tax inversion purposes, penalizing companies who boosted their value through prior transactions with foreign-based firms.

That includes the acquisition of Actavis Inc. by Watson Pharmaceuticals that gave Actavis (now Allergan) its Dublin, Ireland headquarters. Saunders took the helm of Actavis after the company bought Forest Laboratories Inc. for *$28bn in 2014* then *executed billions of dollars* in additional transactions, including the *$66bn acquisition* of Allergan Inc. Through it all, the company kept its Irish legal residence.

Without A Deal, What's Next for Pfizer And Allergan?

Now that the Treasury Department has scuttled the *Pfizer-Allergan merger*, what will the companies do next to create value for shareholders? Both have plenty of options.

Pfizer could keep the cash it would've invested in Allergan and use it to buy stock back from investors in a massive, multibillion-dollar share buyback campaign. The company also is likely to *break apart into separate growth and legacy businesses* – a plan that was essentially put on hold while Pfizer completed the Allergan deal and absorbed the firm's operations.

The big pharma also could spend the money on multiple smaller deals with specialty pharma companies or biotech firms to bolster its research and development pipeline. And, of course, Pfizer could reinvest in internal R&D, which the company has *said it would continue* to prioritize after the Allergan merger.

Saunders was put in the position, before and after the merger with Pfizer was announced, of defending his company's R&D strategy, which *relies on outside firms* to source development programs usually after the drug candidate achieves clinical proof-of-concept. Allergan has *more than 70 active* drug and device development programs in the clinic, including 13 assets that are expected to generate between $250m and $2bn in peak annual sales.

Allergan is likely to continue its acquisitive streak now that it doesn't have to focus on closing the Pfizer merger deal. The company had *$15.1bn in 2015 sales* and ended the year with $1.1bn in cash following Actavis's acquisition of Allergan in the middle of the year.

However, the company will collect $36bn in cash plus $4.5bn in Teva Pharmaceutical Industries Ltd. stock from the $40.5bn *sale of its generics business to Teva*, which should *close during the second quarter* of 2016 despite *ongoing regulatory reviews* around the world.

The Teva transaction will give Allergan plenty of cash to leverage with new debt for future acquisitions within its key therapeutic areas: ophthalmology, aesthetics/dermatology, central nervous system (CNS), gastrointestinal (GI) diseases, women's health/urology, anti-infectives and biosimilars.

Potential acquisition targets may include big industry players, such as Biogen, Bristol-Myers Squibb Co., AbbVie, GlaxoSmithKline PLC or AstraZeneca PLC. However, Allergan also is likely to focus on smaller licensing deals and purchases as well, including mid-sized orphan and specialty pharma companies and more obscure biotech firms with high-value drugs or promising mid-stage development programs.