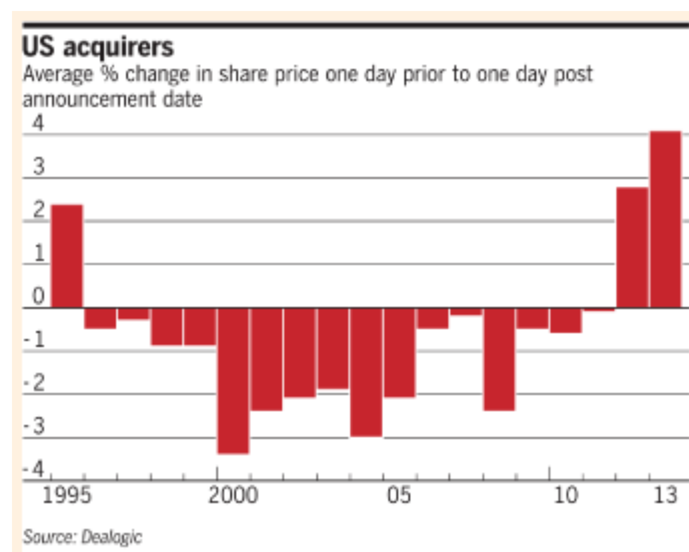
VALUE INVESTMENT INSTITUTE

Specialty Drug Industry – the Alchemy of Finance?

Different this time?

A recently published article in the *Financial Times* grabbed my attention. Citing data from *Dealogic*, it claimed that in 2012 and 2013 investors rewarded companies with increased share prices after announcing an intention to acquire another company. This is something I had expected based on my own observations, but the Dealogic data seems to have some rigour behind it. This information is unusual and interesting, because it contrasts with the negative reaction typically observed in prior years. See the chart below for context.



Students of financial history will know that acquisitions typically destroy value for shareholders in the acquirer, hence the traditional negative reaction of investors to acquisition announcements. The article quotes a failure rate of acquisitions of around 70%, which tallies with a number of studies I have observed in the past. It seems to me that the current phenomenon is likely a function of today's vanishingly-low interest rates. Ultra-cheap credit and low opportunity costs have fostered a radical change in equity investors' attitudes towards deal making. This has been buttressed by the attitude of the credit providers who, if the data on 'cov-lite' loans and PIK note issuance is anything to go by, will warmly embrace nearly any opportunity to lend these days.

These days, there may be no better example of this phenomenon at work than in the specialty drug industry. **Valeant Pharmaceutical** (VRX) is a roll-up strategy that has, thus far, achieved seemingly outstanding results. So outstanding that there are now a number of copy-cats hoping to replicate its successes. These include **Actavis** (ACT), **Endo Pharmaceutical** (ENDP) and, to a lesser extent, **Forest Labs** (FRX). (We note – with a raised eyebrow – the recent

announcement of a tie-up between two of these copy-cats, Actavis and Forest Labs.) It seems that each time Valeant even mentions a potential deal, the stock rises – and ACT and ENDP rise with it in sympathy. With each deal, investors seem to build in expectations of further earnings accretion on future deals – deals that have not even been conceived yet. There is exuberance in investors' attitudes here. However I cannot be certain whether that exuberance is irrational yet. To make such a conclusion, one would have to undertake really thorough research and I have not done so yet. It is also not fair to over-generalise; I am most familiar with Valeant's strategy and know a lot less about ACT, ENDP and FRX. It appears as though the strategies vary somewhat amongst the group.

At the risk of generalising......

In essence, the roll-up strategy is underpinned by access to cheap debt, which can be used to acquire another business, which in turn possesses seemingly durable cash flows. These cash flows are enhanced by cost synergies (closing head office, consolidating manufacturing, reducing / eliminating Research & Development) and revenue synergies (selling the newly acquired products over a wider network). The icing on the cake is access to a very low tax rate, often through re-domiciling intellectual property to countries such as Ireland. Unsurprisingly, the earnings accretion can be vast and the value-added can be enormous if the model is sustainable and the deals get bigger. Maybe because I am a natural cynic when it comes to acquisitions, I am a wary observer of these unfolding events.

Having said that, I am somewhat sympathetic towards the bull case, at Valeant anyway. I have been following the CEO Mike Pearson over the past year or so and he speaks really impressively. The core element of the strategy makes perfect sense (work hard, deploy capital in a return-enhancing manner, avoid risky R&D, avoid auctions) and I applaud it. Also, his personal stake in Valeant is worth around $400 million, so his interests are aligned with other shareholders'.

Is the Pharmaceutical business naturally suitable for roll-up strategies?

Not really, I would argue. John Malone's TCI is perhaps one of the greatest examples of a successful roll-up strategy. However, the cable business is a classic scale business where adding more customers lowers unit costs (content and distribution costs are fixed). The pharmaceutical business is not well designed to benefit from economies of scale in nearly the same manner. It is not really a scale business, as evidenced by its highly fragmented nature.

There are ways in which the roll-up strategy might work. For example, there could be spare capacity in the acquirer's sales network, with sales reps selling too few products. Here the combined sales force can be reduced significantly, creating cost synergies. However, presumably the spare capacity is used up after a few deals – and then what? Perhaps by steadily acquiring small fry year after year, the acquirer can steadily create cost synergies through constantly utilising the enlarged sales force more efficiently than the acquirees could. But won't other vultures also see this opportunity, causing a re-pricing of the potential target companies? Valeant's Pearson claims there are so many private companies that there will

always be deals to do and he sees no evidence of troublesome price inflation in Valeant's areas of interest.

Low interest rates will clearly not provide any sustainable source of value-add for acquirers. Management skill might (identifying undervalued assets and managing them better than others), but clearly only a few can conceivably benefit from skill.

Another source of value that the acquirer might add may come from a structurally low tax rate – lower than attainable by either the target or other acquirers. Maybe I am naive, but I feel uneasy accepting this.

Overall I am hesitant about jumping on the roll-up bandwagon. There are a number of particular reasons why.

<u>The Base Rate</u>

If 70% of acquisitions destroy value, why do managers still acquire? Maybe it is because they believe they will be in the minority of success stories – but they are over-confident and ignore the base-rate that suggests each deal is more likely to fail than succeed. Right now, the market is giving the benefit of the doubt to acquisitive companies.

<u>Cheap debt has a downside</u>

These days, investors are so enamoured by 'earnings accretion' that managers are often not even asked about the form or term of the debt funding. What if the debt can't be refinanced in the future? What if interest rates rise dramatically? (One thing is for sure, they can't fall by much). Also, the accretion only exists whilst the debt is present. If market sentiment changes and the debt has to be repaid, potentially by raising equity at low prices, not only will the accretion disappear but dilution will kick-in.

<u>Accretion versus Value-Add</u>

Accretion measures the degree of enhancement to a single year of Earnings per Share. Every deal varies, but most acquisitions, even if they work for shareholders, pay off over perhaps twenty-plus years. Accretion can look great, but there is a lot of time for things to go wrong.

<u>How durable are the cash flows?</u>

In the case of Valeant, it avoids most of the R&D that previous managements undertook, claiming it is too risky. I have a lot of sympathy for this. Nevertheless, it remains to be seen what happens to the underlying cash flows, if and when the acquired product sales reverse. It is not clear if Valeant is investing sufficiently in replenishing its capital stock. Investors simply can't see the wood for the trees yet because the pace of acquisitions has been so torrid and there are just too many moving parts. Take 2012 for example (2013 results not in at time of writing). In June 2012 Valeant projected FY2012 adjusted-EPS of $4.45-4.70 and adjusted-operating cash flow of at least $1.4bn; subsequently it actually reported GAAP *loss* per share of

$0.38 and operating cash flow of $657 million. How meaningful are the adjusted-earnings and -cash flow numbers?

Cheerleading analysts/investors

I struggle to find any sell-side analysts discussing the risks around this roll-up model. *"Congratulations on the deal"* is the order of the day on the conference calls. Perhaps these deals all make great sense but there is a perceptible pressure on management to do deals, rather than to explain the merits of the deal they have just announced. Companies that are not acquiring are coming under pressure to do so. This feels dangerous to me.

Aggressive tax arrangements?

Tax avoidance measures are commonplace these days and there is always a degree of faith required by investors in multi-national companies employing such measures. However these arrangements are central to the roll-up model and I hazard a guess that very few (if any) of the supporting analysts understand how some of these companies can achieve global tax rates in the teens (percent) or lower. **Perrigo** purchased **Elan** in 2013, primarily to acquire its Irish tax domicile, into which Perrigo can transfer its intellectual property. Actavis did the same with **Warner Chilcott**. But some of the more recent tax-related transactions feel somewhat aggressive to me. Recently Endo Pharmaceutical, a US company, announced it intends to acquire **Paladin Labs**, a Canadian company, and use this transaction as a springboard to re-domicile to Ireland for tax purposes. **Alexion Pharmaceutical**, another US company, recently surprised analysts by announcing an unanticipated relocation of its tax domicile to Ireland, seemingly facilitated by the purchase of a factory and the shift of some supply-chain operations to Ireland. I am not alleging there is anything wrong with these transactions, but I have some concern about whether tax authorities in the US and Europe will continue to indefinitely facilitate such arrangements. The CEO of **Allergan** was recently questioned about his desire to acquire an Irish tax domicile, to which he responded: *"This is the latest fashion in financial engineering, until the roof comes off and someone changes the rules…I am not swayed by that."*

Intangible risks

In attempting to integrate so many deals, will managements be stretched too thinly? In cutting costs with such ferocity, are unseen risks developing? Also, cultural factors might be worth considering. An example of an obviously dangerous acquisition that went effectively unopposed by investors was **Daiichi Sankyo's** acquisition of Indian drug company **Ranbaxy** in 2008. It has been a complete disaster, with Ranbaxy incapacitated by regulatory investigations into manufacturing deficiencies ever since. The Japanese company has been unable to improve matters, despite efforts over the past five years. The Ranbaxy whistleblower who alerted US authorities to the problems said in a recent interview with the *Financial Times*, "*imposing a culture based on honour and trust on top of one that values short-cuts and making a quick buck at the expense of others doesn't really work well*". As we know, corporate cultures can vary greatly even within the same country.

Conclusion

The recent change in investor sentiment towards acquisitive companies is striking. It appears to me that the newly found enthusiasm is beginning to influence the disposition of management teams. This is troubling. History tells us that most acquisitions destroy value. This should cause investors in acquisitive companies to – at the very least – pause for thought. The base rate should not be neglected. Acquisitions often fail for good reasons – there are myriad operational, financial and cultural challenges involved and these are often under-appreciated by the acquiring managers. Furthermore, rock-bottom interest rates won't last forever and nasty surprises may await if companies are unable to refinance on reasonable terms. For investors in aspiring acquisitors, in these times of exuberance, we advise caution.

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