

Do Drug Companies Make Drugs, or Money?

By Andrew Ross Sorkin

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Photo



Allergan is the maker of Botox. Credit Win McNamee/Getty Images

“I just want to emphasize that this is an industry where it is composed of really great people, working to do good things for patients, for doctors and actually for society, and when I look at our employees, there is sort of a noble purpose to working in the pharmaceutical industry.”

That was Mike Pearson, the chief executive of [Valeant Pharmaceuticals International](#), waxing poetic last week about the virtues of his company. He was doing so as he was trying to sell shareholders of [Allergan](#), the maker of Botox, [on his company's \\$53 billion takeover bid](#).

Mr. Pearson may have wrapped himself in the promise of the pharmaceutical industry's ability to deliver lifesaving breakthroughs, but there's a not-so-small problem with his self-righteous

declaration: Of virtually every big drug company, Mr. Pearson's may very well be among the least innovative.

To the extent Mr. Pearson has succeeded over the years, he has done so largely by sharply cutting research and development budgets, arbitraging tax domiciles — Valeant left the United States for Canada's lower tax rates in 2010 by merging with Biovail — and buying rivals so he can cut their costs, too, while they take advantage of his lower tax rate.

Bill George, a professor of management practice at Harvard Business School and the former chairman and chief executive of [Medtronic](#), recently asked a provocative question: "Is the role of leading large pharmaceutical companies to discover lifesaving drugs or to make money for shareholders through financial engineering?"

Mr. George asked the question in the context of [Pfizer](#)'s recent failed bid for AstraZeneca, but he could have been talking about Valeant.

Mr. Pearson's Valeant famously teamed up with Bill Ackman, the activist investor who runs Pershing Square Capital Management, to buy nearly 10 percent of Allergan's shares through a complicated transaction that some suggested was tantamount to front-running. It hoped to use that leverage to persuade Allergan's shareholders to accept Valeant's bid, which it has now raised several times.

Over the last several weeks, Mr. Pearson and Mr. Ackman have engaged in all sorts of criticism and name-calling of Allergan and its chairman and chief executive, David E. I. Pyott.

Mr. Ackman called Mr. Pyott conflicted and said he "appears to be motivated more by personal animus than by what is in the best interest of Allergan shareholders."

That kind of language may just be part of the game, but it is particularly curious because Allergan isn't one of those horribly managed businesses that are often the targets of such vitriol. Here's what the investment firm Sterne Agee said in its recent research report: "The Allergan executive team is one of the best and most shareholder-focused in the pharmaceutical industry." The numbers tell the story: Allergan's stock is up 290 percent over the last five years.

And so what we're left with isn't a tale about a brilliantly innovative drug company trying to buy a mismanaged fixer-upper; it's quite the opposite. Valeant, desperate for ways to increase its revenue, needs a cash cow to milk until it can find the next one.

"Allergan spends 17 percent of its revenue on research and development, compared to Valeant's 3 percent, and Valeant has said it plans to cut around 20 percent of the combined companies' 28,000 jobs in the merger. We do not believe that this is the sort of economic activity that policy makers should be actively encouraging in their rule-making (or foot-dragging)," Martin Lipton, the co-founder of Wachtell, Lipton, Rosen & Katz, which has long railed against the short-term nature of activist investing, wrote in a note to clients. Given his views, it shouldn't come as a surprise that Mr. Pyott hired Mr. Lipton's firm to help defend against Valeant.

In case there is any question about Valeant's slash-and-burn strategy, here is Mr. Pearson in his own words from last week on the value of research and development: "There has been lots and lots of reports, independent reports, talking about how R.&D. on average is no longer productive. I think most people accept that. So it is begging for a new model, and that is hopefully what we have come up with."

Mr. Pearson isn't completely wrong: Research and development has proved to be less efficient at producing blockbusters than it was decades ago. But that doesn't mean the goal should be to try to purge research and development budgets simply to pay out bigger short-term dividends.

And here is Mr. Pearson on his tax-dodging strategy: "As I think maybe you are aware, we were able to get a corporate tax structure which took our effective tax rate from 36 percent over all to what was actually 3.1 percent, which we hope to continue to work on and move lower." How much lower can it go?

Mr. Ackman, who has a terrific investment performance record and a mixed activist record — he practically destroyed [J. C. Penney](#) while doing miraculous work to resuscitate General Growth Properties — has been encouraging Mr. Pearson to increase his offer to induce Allergan to the negotiating table. On Friday, he announced a new twist that he implied should make it clear this is no short-term play for him.

"Early this morning, I called Mike and offered to give up \$600 million of value to the other Allergan shareholders and exchange our shares for Valeant stock if Valeant were prepared to increase its offer to the other Allergan shareholders," Mr. Ackman said in a statement. "We believe that our gesture to the other Allergan owners makes an extraordinarily strong statement about our belief in the long-term value of this highly strategic business combination."

Of course, the saddest part of this battle between Valeant and Allergan is you never really know if the target is trying to defend itself against a deal it knows to be destructive or if it is just playing its well-rehearsed part in a negotiating dance to obtain a higher price. But if Allergan sells, you know the outcome.

Correction: June 4, 2014

The DealBook column on Tuesday, about Valeant Pharmaceutical's bid for Allergan, the maker of Botox, misstated, in some copies, the number of jobs that Valeant has said it will cut in the merger, using information from a law firm's note to clients that was later revised. The company has said it plans to cut about 20 percent of the combined companies' 28,000 jobs, not 28,000 jobs total.

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